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FmHA's Efforts Against Delinquent Borrowers: Property Interests and Transaction Costs

Terence J. Centner and Fred C. White

A recent judicial decision has precluded the Farmers Home Administration from employing nonjudicial foreclosure proceedings in some states. Characteristics of FmHA loans and borrowers suggest that a potential "hold-up" problem exists whereby borrowers may cause the value of their mortgaged properties to diminish below the outstanding balance of the loan. Empirical results of a survey show that the preclusion of nonjudicial foreclosure increased FmHA's direct losses from delinquent borrowers.

Key words: FmHA, foreclosure, property interests, transaction costs.

The Farmers Home Administration (FmHA), an important lender in the agricultural sector, has recently been confronted with an inordinate number of delinquent borrowers (table 1). Poor performance in the agricultural sector, declining farm real estate prices, and potential deterioration of rural residential and other farm structures have contributed to the delinquency problem and have led FmHA to initiate foreclosure and voluntary conveyance actions in order to protect its security interests in mortgaged properties. In 1984, FmHA's ability to use the remedy of nonjudicial foreclosure against delinquent borrowers was limited by a federal court decision.¹ Data concerning delinquent FmHA rural housing borrowers suggest that the "power of sale" clause in FmHA's loan

agreements constitutes a crucial element of a minimum-cost, quality-policing arrangement.

Nonjudicial foreclosure is an essential contract remedy because transaction costs at contract formation and breach can create a "hold-up" problem wherein the foreclosure of FmHA-financed real estate occurs after the value of the property drops below outstanding debt. Wealth-maximizing borrowers are able to deviate from, or renege on, the terms of their FmHA loan agreements to the detriment of FmHA. FmHA needs the abbreviated process of nonjudicial foreclosure to minimize the ensuing waste of public resources.

Transaction costs arise at contract formation and when there is a breach of contract because of uncertainty of responses and level of performance. The major transaction cost at formation of the agreement is the uncertainty of borrower performance. Because FmHA loan programs are generally for high-risk borrowers, FmHA's transaction costs at formation may be expected to be greater than those incurred by private lending institutions. Transaction costs associated with a breach of contract may include a "capitalized interest subsidy" and disincentives for delinquent borrowers to relinquish their properties. At the same time, uncertainty may operate as an impediment against claims of a breach of contract (Klein).

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¹ *Johnson v. United States Department of Agriculture*, 734 F.2d 774-89 (11th Cir. 1984). This case is not to be confused with *Coleman v. Block*, 562 F. Supp. 1353-68 (N.D. 1983), a decision from North Dakota which enjoined FmHA from taking adverse action without proper notice and hearing requirements against persons holding FmHA farm program loans. Although *Coleman v. Block* did not involve nonjudicial foreclosure, the court's response of delaying FmHA action against delinquent borrowers may have resulted in additional transaction costs similar to those discussed in this paper.

Table 1. FmHA Borrower Distress

	Farm Program Borrowers	Single Family Housing Borrowers
Active borrowers behind schedule payment	79,534	5,299 ^a
Filed bankruptcy petitions	4,018	N/A
Discontinued farming or loss of housing due to bankruptcy	811	120
Foreclosure action pending	980	N/A
Voluntary conveyances	1,090	N/A
Borrowers discontinuing farming due to financial difficulties	4,695	N/A
Supervised bank accounts	38,988	13,889
Loan rescheduling or reamortization	120,098	6,718

Source: U.S. Department of Agriculture, Farmers Home Administration, "Farm and Housing Activity Report," 30 Sep. 1985.

Note: Selected data for fiscal year ending 30 Sep. 1985.

^a Data from U.S. Department of Agriculture, Farmers Home Administration, "Farm and Housing Activity Report," 31 Jan. 1986.

FmHA's contractual loan agreement does not contain explicit terms for every contingency and, therefore, is accompanied by attendant costs of negotiation, supervision, enforcement, and risk (Alston, Datta, and Nugent; De Alessi; Dugger). The absence of specified or enforceable contract terms may cause ordinary market remedies, such as judicial foreclosure, to be unsatisfactory. Incomplete contracts may also subject contractees to postcontractual opportunistic behavior (Klein, Crawford, and Alchian). Williamson delineates the employment of arbitration, specific-performance, or other elaborated governance apparatus as neoclassical contract remedies to provide relief from costs involved with incomplete contracts.

This paper analyzes FmHA real estate loans and judicial constraint precluding the use of the contractual remedy of nonjudicial foreclosure. It commences with an overview of the pertinent elements of FmHA's real estate loan programs and a review of the institutional remedies available for use against delinquent borrowers. An economic analysis follows, viewing borrowers' statutorily created property interest as a normative property right (Dragun). An investigation of performance of contract theory discloses uncertainties accompanying FmHA loans which create a "hold-up" problem.

FmHA Loan Programs and Institutional Remedies

FmHA has several different loan programs to provide credit to various members of the rural community. These programs include not only traditional farm ownership and operating loans but also soil and water conservation loans, recreation loans, rural housing loans, resource conservation and development loans, and emergency loans (U.S. Code, Titles 7 and 42).

This paper focuses on FmHA's farm ownership and rural housing loan programs (U.S. Statutes). Persons borrowing funds from FmHA pursuant to the legislative and regulatory provisions of both the farm and home ownership loan programs are required to sign a promissory note which provides for the borrowers' repayment of principal and interest in accordance with schedules and repayment plans prescribed by the secretary of agriculture. FmHA farm ownership borrowers may qualify for low interest rate loans, while individual home ownership loans have adjustable interest rates determined by a formula which takes into account the homeowners' income (C.F.R., Title 7, §§ 1943.18; 1944.25).

FmHA uses standardized notes for its real estate loans containing specialized conditions and terms to secure the payment of the loan with interest, protect the security, and assure that the housing and other property will be maintained in repair. The standardized notes contain a "power of sale" provision whereby borrowers agree that, if borrowers fail to make timely payments and certain conditions concerning loan delinquency are met, FmHA can accelerate the loan so that the entire amount of the unpaid principal is due. Failure to pay the entire amount of the loan would enable FmHA to foreclose under state law. This provision allows FmHA to foreclose through a nonjudicial procedure in states having legal authority for nonjudicial foreclosures.

Institutional remedies available to FmHA against delinquent borrowers are voluntary and involuntary bankruptcy proceedings,² judicial

² This includes liquidation under the provisions of chapter 7 of the Bankruptcy Code, reorganization under chapter 11, or adjustment of debts of an individual with regular income under chapter 13. U.S. Code, Title 11, §§ 701, 1101, and 1301 (1982). The 1986 Amendments to the Bankruptcy Code introduced a new option, "Chapter 12—Adjustment of Debts of a Family Farmer with Regular Annual Income."

and nonjudicial foreclosures, and voluntary conveyance of secured property from a borrower to FmHA for satisfaction of the debt. Because involuntary bankruptcy proceedings cannot be initiated against farmers, as defined by federal bankruptcy law,³ foreclosure and voluntary conveyance constitute the viable remedies for the protection of FmHA's interests in mortgaged farm real estate. Involuntary bankruptcy may be employed against delinquent housing borrowers. In many cases, however, foreclosure is the most appropriate remedy for the preservation of a lender's interest in mortgaged properties, the removal of borrowers-debtors from the property, and the recoupment of a lender's investment through the sale of the property to a third party. The remedy of voluntary conveyance is also available, but the general reluctance of persons voluntarily to convey their property to lenders limits the usefulness of this remedy.

Approximately twenty states have two types of foreclosure procedures: judicial foreclosure, which involves a time-consuming court proceeding, and nonjudicial foreclosure, which involves an abbreviated judicial process in situations where the borrower has previously agreed to such a procedure. A nonjudicial foreclosure avoids court costs and property holding costs that typically accompany a judicial foreclosure because it enables a lender to foreclose against delinquent borrowers without proving that the lender followed all applicable rules and procedures in accelerating the loan. The nonjudicial procedure thereby denies borrowers a substantial procedural advantage inherent in the judicial foreclosure procedure that is available in all fifty states.

The legislative parameters concerning the qualifications and amount of funds available to borrowers and the administrative provisions delineating the rights of FmHA and borrowers in the referenced property present FmHA borrowers the economic choice of participating in the FmHA loan programs within a restricted opportunity set. As noted by Runge,

various property institutions contain different vectors of characteristic rights that delineate the benefits being channeled to various agents. FmHA borrowers who desire governmental funds to facilitate the acquisition of real property are required to sign a note that contains a power of sale clause. Thus, borrowers' property rights are conditioned upon FmHA's ability to use a legislatively sanctioned nonjudicial foreclosure procedure if borrowers default on the note (Centner).

A Contractual "Hold-Up" Problem

Each FmHA loan involves specific real property. It thereby concerns a specialized or highly firm-specific investment which means that both the borrowers and FmHA have a strong incentive to see the contract through to conclusion (Williamson). Failure to complete a contract incurs transaction costs. Repossession of property could entail a loss when specialized property is less valuable to a successor purchaser. Borrowers who fail to make payments and/or fail to maintain mortgaged properties adequately may preclude lenders from recouping the outstanding balance of a loan. At the same time, delinquent borrowers may benefit by their ability to continue to live in subsidized housing at a cost below the market rate of substitute housing.

Borrowers with collateral that declines or is declining in value below the outstanding balance of the debt may maximize their wealth by delaying or precluding lenders from taking action to repossess the collateral. This situation has recently been present with some FmHA loans. Klein has labeled the transaction costs present when a wealth maximizer is able to renege on a transaction to his or her advantage as a "hold-up" problem. Accepting contract theory advanced by Klein and Williamson, the "hold-up" problem may justify the coercive power-of-sale term of FmHA's loans as a crucial element of a minimum-cost, quality-policing arrangement.

The contractual agreement embodied in FmHA's standardized note was incomplete as it contained uncertainties concerning borrowers' ability to perform and level of performance. Borrowers' ability to repay the borrowed funds depended upon both endogenous factors, such as management skills or gainful employment of borrowers, and exogenous fac-

³ Federal Bankruptcy law defines a farmer as a "person that received more than 80% of such person's gross income during the taxable year of such person immediately preceding the taxable year of such person during which the case under this title concerning such person was commenced from a farming operation owned or operated by such person" [U.S. Code, Title 11, § 101(17) (1982)]. "Farming operation" includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state" [U.S. Code, Title 11, § 101(18) (1982)].

tors, such as the natural elements (drought, hail, freezes, etc.), commodity prices, and real estate values. These factors precluded a complete guarantee of performance of the contractual loan agreement.

Borrowers' level of performance was likewise uncertain. Since the legislation indexes loan repayments to borrowers' income, borrowers have a diminished incentive to find more lucrative employment. The indexing provision constitutes an institutional constraint which enables borrowers to hold up rents being paid to FmHA in the form of mortgage repayments through underemployment. An additional factor that may influence borrowers' level of performance is the possibility that Congress may grant further concessions, through new or amended welfare legislation.

However, even more significant is the fact that borrowers rather than lenders control the level of upkeep and maintenance of the mortgaged properties. Given the nature of housing and agricultural real estate, timely repairs and acceptable husbandry practices are closely linked to the future value of the property. Sodbusting on fragile soils and destruction of conservation structures such as terraces are examples of farming practices that may increase short-term economic gains at the expense of longer-term productivity of soils, and hence, market values of properties. Failure to maintain houses, farm buildings, and other realty also tends to diminish the future value of real estate.

Since many FmHA loans advance a large percentage of the market value of the property and the initial payments on a loan are comprised mainly of interest payments, the value of FmHA's collateral at the time the loan is made may not be much greater than the amount of the loan. Any deterioration of FmHA-financed real estate may cause its value to diminish so that it is less than the amount of the outstanding debt. Lower rates of appreciation in the overall housing market and major downward adjustments in agricultural real estate values in the 1980s relative to earlier periods have accentuated the problem of real estate values falling below the balance of the outstanding debt.

Another element associated with transaction costs of the "hold-up" problem is the fact that the FmHA loan program provides credit for applicants who could not otherwise obtain credit for such a purpose, with interest rates

that are generally below market rates. The subsidy on interest rates may be expected to be taken into account in investment decisions by borrowers. FmHA borrowers with subsidized credit may make economic decisions pertaining to purchase prices of housing, farm real estate, and farming operations that would not be appropriate without subsidized credit. Considering the market power of initial sellers and competition among potential buyers, subsidized credit may become capitalized into the purchase price of the property, resulting in higher property prices. However, these higher property prices may not be sustained if subsequent buyers do not also receive an interest subsidy. In some cases, the property is resold only on the basis that potential purchasers can themselves qualify for FmHA or similar government-financed credit programs. Sometimes, the capitalized subsidy would have to be discounted for potential purchasers in order for the property to be resold.

Taking into account the capitalized interest subsidy and the depressed economic conditions in agriculture, the fact that many of these FmHA-financed properties cannot be resold readily at the purchase price creates problems for innumerable borrowers. Because borrowers may be unable to get their equity out of such properties, their incentives to invest in maintenance and repairs and use conservation-oriented husbandry practices are diminished. Furthermore, low incomes make it difficult for many borrowers to properly maintain properties or to make timely repairs.

If FmHA borrowers fail to make timely investments in maintenance and repairs or use appropriate husbandry practices, the benefits from residing in the house and/or operating the farm will decline. These effects tend to accumulate through time. Assuming no transaction costs on the part of the borrower associated with default, an FmHA borrower rationally would default whenever the marginal benefits derived from continued ownership of the property fall below marginal costs. However, defaulting borrowers incur transaction costs. These costs include the cost of relocation and increased difficulty in obtaining further credit. The positive value of transaction costs associated with default may cause FmHA borrowers to continue their farming operations and/or remain in their residences until the salvage or market value of the property is considerably below the outstanding debt on the

Table 2. Characteristics of Foreclosures and Voluntary Conveyances under the FmHA Rural Housing Loan Program, 1984-85

	Foreclosures		Voluntary Conveyances
	Judicial	Nonjudicial	
Average amount of debt (\$) ^a	36,857	47,100	40,634
Average property value (\$)	29,812	43,974	37,311
Average direct loss to FmHA (\$) ^b	7,045	3,126	3,323
Length of time to complete foreclosure process (mos.)	22.4	5.8	
Average number of property transfers	77	144	339

Note: States reporting only judicial foreclosure procedures were Florida, Georgia, Hawaii, Illinois, Louisiana, Maine, Montana, Oklahoma, and Pennsylvania. States reporting only nonjudicial foreclosure procedures were Alaska, California, Missouri, and Virginia. Washington reported the use of both judicial and nonjudicial foreclosure procedures.

^a Average amount of debt on the property conveyed to FmHA includes principal and interest.

^b Average direct loss to FmHA is average property value minus average debt outstanding.

loan. The difference between salvage or market value and outstanding debt on the property can be considered a form of "hold-up" by wealth-maximizing borrowers.

Empirical Results

The forty-six FmHA state offices were surveyed to determine the magnitude and characteristics of foreclosures and voluntary conveyances in FmHA's rural housing loan program in the fiscal year 1984-85. This could be considered a typical year for the rural housing loan program because delinquencies have not escalated in this program as they have in the farm loan program.⁴ One-third of the state offices responded with complete information. A list of those states responding to the survey and a summary of the responses are reported in table 2. On the 1984-85 foreclosures and voluntary conveyances of rural houses, the average debt owed to FmHA was higher than the average property values, as measured by the price for which FmHA resold the properties. FmHA had a direct loss of \$7,045 per house on housing properties under judicial foreclosures, compared to \$3,126 under nonjudicial foreclosures. With a *t*-statistic of 1.806, these means were significantly different at the 10% level of significance. Direct loss under voluntary conveyance was \$3,323 per house. There

was statistical difference (at the 5% level) between direct losses under judicial foreclosure and voluntary conveyance, but no significant difference between nonjudicial foreclosure and voluntary conveyance.

This direct loss does not take into account the indirect loss related to FmHA expenses incurred in the process. Although no data are available to measure these expenses, the length of time needed for FmHA to divest delinquent borrowers of their rights in real estate gives some indication of the relative magnitude of the indirect expenses under judicial versus nonjudicial foreclosure procedures. On the average, it takes 22.4 months between initiation and completion of judicial foreclosures compared to 5.8 months for nonjudicial foreclosures. These means were statistically different at the 1% level of significance.

The average number of voluntary conveyances per state was 339 during fiscal year 1984-85. States with judicial foreclosure procedures averaged 77 foreclosures, while states with nonjudicial foreclosures averaged 144 foreclosures. These means were not statistically different. States using judicial foreclosure procedures had four voluntary conveyances per foreclosure, states with nonjudicial foreclosure procedures had two voluntary conveyances per foreclosure. A possible explanation for these differences is that the threat of judicial foreclosure procedures may have caused more borrowers to convey their property voluntarily to FmHA rather than go through the judicial foreclosure procedure. Alternatively, the non-availability of a nonjudicial foreclosure procedure may have prompted FmHA to use greater efforts to reach accommodation with

⁴ The percentages of borrowers delinquent under FmHA's Individual Housing programs during 1978-85 were: 1978, 21%; 1979, 21%; 1980, 25%; 1981, 26%; 1982, 22%; 1983, 20%; 1984, 18%; and 1985, 20% (U.S. Department of Agriculture, Farmers Home Administration, *Brief History of Farmers Home Administration*, Feb. 1986).

delinquent borrowers for the voluntary conveyance of mortgaged properties.

States with nonjudicial foreclosure procedures experienced lower average losses on houses that were voluntarily conveyed to FmHA. Direct losses to FmHA on voluntary conveyances were \$2,400 per house in those states with nonjudicial foreclosure procedures and \$3,872 per house in those states with judicial foreclosure procedures. Hence, it appears that the nonjudicial foreclosure procedure could be used as a technique to reduce direct losses to FmHA on delinquent loans.

The aggregate magnitude of the "hold-up" problem in FmHA's rural housing loan program can be roughly approximated from the data in table 2. Assuming two-thirds of the states are employing judicial foreclosure procedures and one-third nonjudicial foreclosure procedures, the aggregate amount of direct loss to FmHA on bad loans for rural housing was estimated to be \$75.4 million annually.⁵ This figure does not take into account FmHA's expenses associated with these bad loans, including expenses related to foreclosures and reselling the properties.

Considering that the average market value of properties foreclosed on or voluntarily conveyed to FmHA is well below the level of debt owed on the properties, these empirical results clearly support the concept of a "hold-up" problem in FmHA's rural housing loan program. Many FmHA borrowers tend to maintain ownership of properties while the property value is deteriorating to levels below the amount of debt owed to FmHA. Institutional changes can be used to reduce the magnitude of the "hold-up" problem. For example, instituting nonjudicial foreclosure procedures in those states presently using judicial foreclosure procedures would have reduced the "hold-up" cost by 56% on foreclosed loans in 1984-85.⁶

Conclusion

Uncertainties inherent in the FmHA farm ownership and housing loan programs create transaction costs. Characteristics of the loan programs and borrowers suggest that the indexed loan repayments, lack of maintenance and repairs, failure to use conservation-oriented husbandry practices, and capitalized interest subsidies accompanying declining real estate values create a "hold-up" problem. The value of borrowers' property may drop below the outstanding value of the loan so that the collateral is insufficient to cover the debt. Data from a survey of FmHA's rural housing program documented losses by FmHA which were greater when a more lengthy judicial foreclosure procedure was used rather than nonjudicial foreclosure or voluntary conveyance.

Transaction costs associated with FmHA loans could be allocated to either borrowers or the government. Legislation could require borrowers to assume responsibility for some of these costs by establishing more stringent borrower entry requirements, shorter repayment schedules, or a property inspection program with borrower fees. On the other hand, Congress could have the government absorb these costs.

An analysis of the applicable legislation and regulations indicates that although Congress condoned risky borrowers, thereby obligating the government to assume numerous transaction costs, this did not include costs of foregoing a judicial foreclosure procedure in those states containing authority for such a procedure. The legislatively bestowed vector of property rights allows FmHA to include a power of sale provision in its loan agreements to provide a remedy for some of the transaction costs that accompany its loans. Borrowers who fail to meet repayment obligations may be subject to nonjudicial foreclosure to enable FmHA to extricate itself quickly from bad loans and prevent the further diminution of value of mortgaged properties.

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⁵ Aggregate direct loss to FmHA was calculated using figures in table 2. With judicial foreclosures, the direct loss was \$7,045 per house times 77 property transfers per state in 31 state offices for a total of \$16.8 million. With nonjudicial foreclosures, the direct loss was \$3,126 per house times 144 property transfers per state times 15 state offices for a total of \$6.8 million. With voluntary conveyances, the direct loss was \$3,323 per house times 339 property transfers per state times 46 state offices for a total of \$51.8 million. The overall total was \$75.4 million.

⁶ The direct loss under nonjudicial foreclosures of \$3,126 per house was 56% lower than the direct loss under judicial foreclosure of \$7,045 per house (table 2).

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