by Elizabeth M. Dietzmann, JD

USDA loan graduation review – what's supposed to vs. what really happens

Before I attempt to delve into the mysteries of graduating a USDA RD loan or the "graduation review" as it is known, I thought I should attempt to establish my credibility. I am an attorney who has spent the last 15 years working with rural water and wastewater districts on every aspect of day-to-day operations, as well as applying for and receiving USDA RD loans. While I am not privy to the inner workings of USDA offices, I have worked with USDA staff on dozens of loans from inception to loan closing. I have also participated directly in the graduation review process with at least a dozen water districts and consulted with water districts across the country that are facing graduation requests by USDA. USDA loan holders are often reluctant to graduate a USDA loan, because this leads to a loss of the 1926b territorial protection that the loans create.

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My purpose here is neither to vilify USDA staff with whom I have worked with for years, nor to blow the whistle on water districts that should or should not have been graduated for the reasons and circumstances that this article addresses.

I do intend to discuss this little known aspect of the USDA RD loan process, describe how it is supposed to work according to USDA's own internal Staff Instruction and then share some actual experiences.

According to Webster's "graduation" is defined as follows:

1. a mark on an instrument or vessel indicating degrees or quantity;
2. the award or acceptance of an academic degree or diploma;
3. arrangement in degrees or ranks.

USDA defines "graduation" as a mandatory refinancing that is supposed to be required when a water district (the "borrower") is in such good shape financially that it can obtain commercial credit. Please note that I use the term "borrower" and "water district" interchangeably for the purposes of this article.

Keep in mind that the initial threshold test for USDA loan eligibility is the fact that the borrower cannot get money anywhere else. USDA is supposed to be the last resort for funding projects that have a direct impact on the quality of life in rural areas. Staff Instruction 1780-6 clearly states:

Applicants must certify when an initial application or request for an eligibility determination is submitted that they are unable to finance the proposed project from their own resources or through commercial credit at reasonable rates and terms. To support the certification, applicants must provide evidence that they have contacted potential sources of commercial credit and of the lender or lenders' response.

A water district is assigned a "servicing official" at the

USDA Rural Development has been in the business of making loans and grants to rural water districts and small cities for decades. Most rural water systems in the U.S. were initially funded through the agency or its predecessor, the Farmers Home Administration.

beginning of this process – usually a loan-servicing specialist from the local USDA Service Center. This person guides the borrower through the loan process. The first thing USDA does is make sure the applicant is unable to get financing from “real” banks. This requirement has its basis in two concepts. First, historically lots of other federal laws restrict the federal government from competing with commercial lenders. Banks want first crack at lucrative loans at commercial rates. Instead of separation of church and state, think separation of state and commercial banking – although in light of recent events, it looks like commercial banks are now a branch of the federal government! Second, the pool of money for USDA loans is limited and comes out of the taxpayers’ pockets, so only those water districts really in need, that are not appealing to commercial lenders, are eligible for funds. (Keep this point in mind, because I will be coming back to it later when I discuss abuses of the system.)

All in all this system makes sense and it certainly made sense back in the 1960s when the rush was on to get clean drinking water to rural Americans and no one could afford to build water systems and no banks were willing to take the risk.

So now it is some time after the water district has received the loan, revenues are coming in, the water district is managing its finances well, and the theory is, that in order to satisfy those two requirements above – not to compete with commercial lenders and to free up more money for other projects – these established water districts are supposed to go out and refinance commercially. In fact, the graduation concept is supposed to be explained at the loan closing and the discussion is supposed to be documented in the “running case record” maintained at the local service center. I personally have never had this topic raised at any loan closing on any project I have handled. I should also point out here that lots of information about each loan and water district operations is supposed to be documented in the running case record. I have never been able to review these records at any local service center. The few service centers that would let me look at my clients’ own records often did not have the records, or could not find them. I have also been told that this information was not available to my client, even though these are public records based on information provided by my client pursuant to federal regulations. Freedom Of Information Act requests were also met with silence or a response that the records were missing. This may not be too surprising when a loan is 25 years old, but it is frustrating nonetheless.

So each water district is supposed to fill out forms once a year for the local service center that basically details how much money the district has in the bank, what outstanding loan balances it has and summarizes the district’s general financial status. Unfortunately, the forms do not

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require annual rate increases or any review of operational policies, but it may be logistically too difficult for local USDA staff to oversee individual water districts to this extent. Service center staff have their hands full getting current projects funded and loans closed. This alone is incredibly time consuming, and one service center staff member may be covering several counties at the same time.

At any rate, these reports filed by the water district are supposed to be the basis for the graduation review, which is a determination by the local service center that a water district should be able to refinance its USDA RD loan and will be required to do so. The actual graduation process is supposed to go something like this according to the Staff Instruction.

(ii) Graduation review period. Graduation reviews will be conducted as follows:

(A) The servicing official will review borrowers who have been indebted for at least five years. The first review for a borrower will be conducted in the sixth year of the newest loan, corresponding to the date of loan closing. All borrowers will be reviewed every third year thereafter. Each year, the servicing official will generate a Graduation Review Report to schedule graduation reviews simultaneously with each borrower's operational review and compliance review

(The blue highlighted language is recent language that has been added to clarify the older policies. I do not know if this is now being followed or not. It has not been so far on any of projects of my clients.)

In a nutshell, every third year a water district is reviewed in order to determine if it should be placed on the graduation list. Those districts are sent a letter from the local service center which notifies them that they need to obtain commercial refinancing of their loan from a lender on a pre-approved list of lenders. These are lenders that USDA RD is supposed to solicit and educate about RD loans, so that they will be willing to take over a loan. The water district is supposed to go out and get commercial refinancing of the loan from one of these lenders, which is then closed out on USDA RD books, thereby freeing up funds to be used on another project for another water district. That is supposed to be what happens. Now this is my experience of what really happens. First, local service center staff and even state office USDA RD staff are often unclear on how the graduation process is supposed to work. The following are actual statements I have been told by USDA RD staff at both the local and state office levels when I have called to ask for details on the graduation review process:

- we are too busy to worry about graduation reviews so we just don't do them;
- we don't have any written policy on graduation reviews;
- we don't have a list of lenders who have agreed to work with USDA – just go ask a local bank;
- just send us a letter telling us that you couldn't get funding – that will suffice;
- we have a graduation review policy but we can't send you a copy – it is an internal document;
- we only do graduation reviews if you are applying for a new loan.

I should also point out that I know service centers that have advised water districts WITH existing USDA loans to give up territory to cities, even though it would impact their ability to repay those loans!

As I am accustomed to dealing with bureaucracies, none of this has ever come as a big surprise. Many of the USDA RD loan forms are out of date. Many of the loan application documents and loan checklists are presented on very old mimeographed forms dating back to the 1970s and are not available electronically. I have even been asked by staff to rewrite forms to reflect current terminology and procedures and send electronic copies to my service center. I have always been more than willing to do this and those forms have been used on subsequent projects.

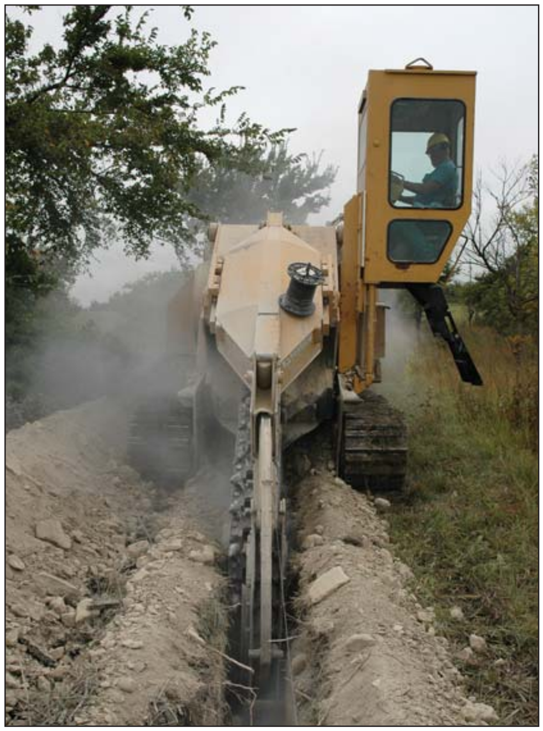
The real problem with the graduation policy is the random and sometimes not so random manner in which it is enforced. I have had water district clients formed in the early 1960s that have had several USDA RD loans and have never received a graduation request letter. It could be these districts have not filed annual reports with the service center in many years. I have also never received graduation request letters on a schedule. In fact, when I have asked numerous sources, I have been told that there is no schedule, a one-year schedule, a two-year schedule and now according to the Staff Instruction, I should be expecting a three-year schedule.

Interestingly enough, when one of my client districts was involved in a heated territorial battle over 1926(b) issues, and the city manager was a friend of the local service center manager, the district suddenly received its first ever graduation request letter on a 20-year old loan. On the flip side, I know borrowers who have several million dollars in the bank, enough to pay off their loan without even seeking outside funding, who are never asked to graduate their loan and who have gone on to apply for and receive additional USDA RD loans purely for the purpose of 1926(b) protection. In fact, one district applied for and received a USDA RD loan in order to build a water line extension to a golf course and to obtain extended territorial protection.

Another water district was advised to voluntarily graduate its loan by a local service center even when that meant that it would lose its existing territorial protection. That district did lose its protection, subsequently losing several hundred existing customers, and then had to apply for a new USDA RD loan in order to afford to upgrade its well so that the remaining customers would continue to have potable water. In order to make that deal work, USDA RD had to kick in a large amount of grant money because the water district didn't have the revenue to service the debt, because they had lost the other customers because they had lost the territorial protection.

The problem is easy to see. I also know of service centers that have advised water districts with existing loans to give up territory to cities, even though it would impact their ability to repay that loan.

Another pet peeve of mine is what I call the "lender list". This is supposed to be the list of commercial lenders in the state who either do business with USDA RD on interim financing or who have been recruited and educated by USDA RD on loan issues. This list, if it even exists in most states, is often hopelessly out of date. The last time I tried to use the list in one state, in order to make a good faith effort to comply with a graduation request, over 50 percent of the commercial banks listed were not currently in business. The remainder of the banks had no current contact information, nor did anyone at one bank have any idea why they would want to refinance a water district loan. They had never even heard about the USDA RD loan program. I finally turned to the nationally-known commercial lender who did around 80 percent of the interim financing on USDA RD projects in that state, only to be told by the local service center that they were not on the lender list!



This photo of a trencher digging through rocky terrain was taken during the installation of a rural water district funded by USDA Rural Development.

One final quirk I have experienced goes back to the water district that was clearly being forced to graduate as part of the local politics surrounding the city's territorial dispute. When I received the request to graduate, it stated that the district had to provide proof from three lenders that no one would take the loan. I started checking with other service centers and was told that I didn't need any independent verification, just a letter from the district; that I needed one letter from a lender; that I needed two letters from lenders. I finally provided one letter and asked for a copy of the regulations or staff instruction that mandated three letters. Never heard another word.

To step back and look at the big picture, what is clear to me is that many of the policies concerning USDA RD loans are antiquated, inconsistently enforced and present the opportunity for abuse. USDA RD staff are wonderful folks to deal with. It is the system that is broken and yes, this all ties into the 1926(b) issues.

The existence of the USDA RD loan is the linchpin of territorial protection. So not only should USDA staff not be advising water districts to give up that protection, the graduation program should not push them to do so. Equally important is the fact that wealthy water districts with lots of cash on hand should not be clinging to their old USDA RD loans and/or getting new ones. Instead they should be graduating those old loans and resolving territorial disputes though other means. As conflicts between cities and water districts become more and more heated, we need to take a look at the entire 1926(b) issue. Simply put, the federal government needs to intervene and resolve these disputes as a matter of policy. Otherwise the only people who suffer when cities and water districts spend hundreds of thousands of dollars on territorial disputes are the customers on both sides.

Frankly, I always thought the customer came first.