
Rising Interest Rates and The SCRA

RISING INTEREST RATES AND THE SCRA CAN PROVE A TRICKY (AND DANGEROUS) COMBINATION

By Brian Nettleingham and Martin Frenkel

The past decade, with prolonged fighting in Iraq and Afghanistan, have had profound effects on our society. The mortgage industry is not immune from the impact of these conflicts which have resulted in large numbers of borrowers entering and leaving the military service. Taking (or failing to take) action relating to a borrower in the military has significant consequences both from a regulatory and public relations standpoint.

In recent years, regulators have imposed massive fines and penalties for violations of the Servicemembers Civil Relief Act (SCRA). Compliance in this area remains critical. The SCRA provides financial protections for servicemembers to help them devote their entire energy to the Nation's defense needs. The act includes three primary protections for military borrowers that relate to the mortgage industry:

Interest Rate Reductions – servicemembers may, under certain conditions, request that their annual interest rate be reduced so that it does not exceed 6%
Default Judgments — mortgage servicers may be prohibited from obtaining entry of default judgments (including in judicial foreclosure actions)
Foreclosures — mortgage servicers are limited in taking certain actions relating to foreclosures involving servicemembers

This article focuses on the first of these protections. As interest rates continue to inch their way back from record lows, a relatively unknown provision of the SCRA may begin to be litigated at levels not seen since the end of World War II. At issue is Section 527 of the SCRA which caps the rate of interest on debts incurred by servicemembers before military service to 6 percent. The penalties for violators include fines and imprisonment!

Under Section 527, “[a]n obligation or liability” incurred by a servicemember

before entering military service bearing an interest rate over 6 percent, shall be reduced to 6 percent or lower “during the period of military service and one year thereafter” for all mortgages and deeds of trust. 50 U.S.C. App. § 527(a)(1). For obligations and liabilities other than mortgages, trust deeds, and similar securities, this section applies only during the period of military service. *Id.*

As defined in this section, “interest” includes more than just the interest rate. It also includes “service charges, renewal charges, fees, or any other charges (except bona fide insurance) with respect to an obligation or liability.” Sec. 527(d)(1). This provision is critical for a couple of reasons. First, even if the stated interest rate on a loan is under 6 percent, the “interest” as defined under Section 527 may actually exceed 6 percent. Second, the definition of “interest” is so open-ended as to include virtually any charge to the servicemember. Creditors will need to carefully examine all charges to determine whether they are charging “interest” in excess of 6 percent in violation of this section.

Under Section 527, all “interest” above 6 percent that would have been incurred is forgiven, the amount of any periodic payment shall be reduced accordingly, and the principal shall not be accelerated. Sec. 527(a)(1-2). However, a court may grant a creditor relief from the requirements under this section if the servicemember “is not materially affected by reason of the servicemember’s military service.” Section 527(c). The burden of proof is on the creditor to make this showing. *In re Watson*, 292 B.R. 441 (Bkrtcy. S.D. Ga.2003).

The effective date for forgiving interest and reducing payments is “the date on which the servicemember is called to military service.” Sec. 527(b)(2). However, it is up to the servicemember to provide written notice and a copy of military orders to the creditor, and notice may be provided up to “not later than 180 days after the date of the servicemember’s termination or release from military service.” Sec. 527(b)(1).

This raises an interesting question if a servicemember pays a higher interest rate during the period of military service but fails to provide notice to the creditor until sometime after being released. Is a creditor required to return monies received in excess of 6 percent? Is continued payment by a servicemember evidence that the servicemember’s military service has not “materially affected” his or her ability to pay interest over 6 percent? The statute is silent. As interest rates continue to rise, be on the lookout for courts providing answers to these questions.

If you would like to discuss further how a servicer may apply SCRA protections to its servicing operations, please do not hesitate to contact Martin Frenkel (248-354-4030; mfrenkel@maddinhauser.com) or Brian Nettleingham (248-354-4030; bnettleingham@maddinhauser.com).

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