Can Eminent Domain Help Underwater Homeowners?

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Several California counties are considering a controversial proposal to use their eminent domain powers to offer relief to underwater homeowners. The plan is quietly being shopped to counties hit hardest by the housing crisis, and it seems local politicians are listening. [1] "We have a very large problem that's causing severe economic problems and part of our exploring ways to deal with it is hearing from people like those representatives of the securities industry," said San Bernardino County Chief Executive Officer Greg Devereaux.[2]

This has provoked a sharp reaction from Wall Street banks. In a letter to San Bernardino Supervisors, a coalition of securities investors said "Such an action would likely significantly reduce access to credit for mortgage borrowers in the San Bernardino area and other areas that undertake similar actions." [3]

It's hard not to sympathize with the Riverside-San Bernardino-Ontario metro area, where half the mortgages are underwater and the unemployment rate for May was 11.8%. [4] And some progressives may find it hard to be sensitive to the plight of the Wall Street banks that hold most of the underwater mortgages in San Bernardino. [5]

But the basic policy question here is whether the proposed cure would be worse than the disease. Using government's eminent domain powers to force investors to eat the losses on underwater mortgages is a very drastic remedy to the problem of negative equity. While it could ease the burden on some homeowners, it could also drive private investment out of California housing markets. This would only prolong the housing slump and deepen the state's economic malaise.

The counties could instead work with private mortgage investors to streamline refinancing efforts for current underwater borrowers, and to implement a measured "shared appreciation" program for targeted delinquent borrowers.

The Proposal

A group of West Coast mortgage companies first hatched the proposal for counties to use eminent domain to buy underwater mortgages. Working with the mortgage companies, they would then negotiate new mortgages more similar to actual housing values. In this way, counties would reduce foreclosures and help people keep in their homes, so that works out for homeowners. The mortgage companies would collect fees for negotiating new loans, so they're winners as well. However, one party would stand to lose big: the owners of the original mortgages (mainly institutional investors in mortgage-backed securities), who would in effect be dispossessed of some of their property by the government action.

"This gets an 'A' for creativity but what are you actually accomplishing?" said Jonathan Lieberman, head of residential- mortgage securities at New York-based Angelo Gordon, which oversees about $24 billion. "The benefit to a few selected homeowners and the profits for the private sponsor will be vastly outweighed by the harm to responsible citizens, homeowners and investors. That's not a legitimate 'public use' for purposes of eminent domain."

Usually, governments use eminent domain to take possession of private property in the interest of a public good, like building new highways or expanding airports. In such takings, governments are required to give property owners just compensation. Under the San Bernardino proposal, the county government would establish fair value and compensate the owners of the mortgage.

The specific loans targeted in this proposal are part of what is known as Private Label Mortgage Backed Securities (PLMBS). These are private investments, meaning no government component or guarantee is backing the underlying mortgages. Loans that are guaranteed by the Federal Housing Administration (FHA), Fannie Mae or Freddie Mac are already owned by the federal government and eminent domain cannot be used to take property from the federal government.

Using eminent domain to devalue private mortgages would compound the already considerable risks involved in housing investments. When a pension fund or other institutional fund invests in mortgage-backed securities, it generally faces three kinds of risk: pre-payments, defaults and rising interest rates. The first risk is that borrowers will pay back the mortgage earlier than expected. For example, when rates go down, many people refinance their mortgages, returning less profit than expected to the investor. The second risk is that borrowers default on their mortgage. The resulting foreclosure usually results in a loss of interest payments and principal to the investor. Third, rising interest rates slam investors who have tied up their capital in loans made when interest rates were lower, as they are now.

As officials in San Bernardino and other California counties contemplate the use of eminent domain to seize mortgages, they should think carefully about the unintended and second-order consequences of this course. Three potential dangers in particular stand out:

1. **Loss of Trust.** Future investors would lose trust in any jurisdiction that uses a policy such as eminent domain to force principal reduction write-downs. In the best-case scenario, investors would charge a significant risk premium in the form of higher interest rates and steeper down payments. According to Scott Simon, mortgage head of PIMCO, the world's largest mortgage bond fund, "It would put another nail in the coffin of the private mortgage market. It just means you're going to need to have monster credit scores and monster down payments if you're ever going to have a private market."[6]

   As a result, mortgage credit would fall further out of reach for would-be homebuyers, exerting downward pressure on home values. This continues the vicious cycle of deeper underwater homes, more foreclosures and a furthering of a depressed local economy. And since a significant portion of local municipalities' revenues are derived from property taxes, this would result directly in spending cuts for counties, including job losses for police officers, teachers and firefighters.

   One of the biggest challenges for many of the Obama administration's housing proposals is that private investors and mortgage-related businesses need to participate in its programs willingly. Creating solutions that work with, not against, private business is essential to make sure the industry is willing to remain part of the mortgage finance infrastructure in the future.

2. **New burdens on U.S. taxpayers.** If private investors flee housing markets to avoid local governments "taking" their property under eminent domain, the federal government will have to step in to fill the vacuum. The big government-backed lending programs (Fannie, Freddie, FHA) would likely become the sole provider of residential mortgage loans. Because Fannie Mae and Freddie Mac, with $190 billion in losses, are now in conservatorship with the federal government, this requires more taxpayer money and with greater risks attached. In addition, according to a report by Amherst Securities[7], new loans would be refinanced using a specific Federal Housing Administration (FHA) refinance program, immediately expanding the government agency's portfolio.

   Simply put, crowding out private capital and expanding government-backed lending conflicts with the widespread, almost unanimous agreement by experts and policymakers on both sides of the aisle -- bringing private capital back into the market is one of our top priorities.

3. **Smaller pensions and retirement accounts.** The average taxpayer's retirement account or pension will take a hit under this proposal. Securi-

> tizations, even private label securities, which are the target of this proposal, are investments made traditionally by institutional investors. In other words, teachers' retirement accounts and firefighters' pensions are the funds that are used for securitizations' investments in order to make mortgage loans. So when the loan is "taken" by eminent domain and the investor is compensated at a severe discount, the difference is a direct loss for that retirement investment or policeman's pension fund.

While the current foreclosure and negative equity crisis that plagues our economy demands innovative ideas and policy solutions, this one has some serious questions that need to be answered before lawmakers proceed.

Endnotes

[1] Steven Greenhut, "Eminent Domain is a Bad Ploy for Underwater Mortgages," *Bloomberg View,* June 28, 2012, http://www.bloomberg.com/news/2012-06-28/eminent-domain-is-bad-ploy-for-underwater-mortgages.html.

[2] Jody Shenn and John Gittelsohn, "Mortgage Seizure Plan Sparks Bondholder Talks With County," *Bloomberg,* June 29, 2012, http://www.bloomberg.com/news/2012-06-28/bondholders-discuss-mortgage-seizure-concerns-with-county-leader.html.

[3] "SIFMA and Other Associations Submit Comments to San Bernardino County on the Joint Powers Agreement of the Homeownership Protection Plan," *SIFMA,* June 28, 2012, http://www.sifma.org/issues/item.aspx?id=8589939260.

[4] Justin T Hilley, "Amherst: Seizing Mortgages by Eminent Domain Unfair To Investors," *Housingwire,* June 28, 2012, http://www.housingwire.com/news/use-eminent-domain-seize-mortgages-leaves-investors-uprotected-amherst.

[5] Brad Miller, "Opinion: No Wonder Eminent Domain Mortgage Seizures Scare Wall Street," *American Banker*, July 11, 2012, http://www.americanbanker.com/bankthink/eminent-domain-mortgage-seizures-terrify-wall-street-1050811-1.html.

[6] Shenn and Gittelsohn, http://www.bloomberg.com/news/2012-06-28/bondholders-discuss-mortgage-seizure-concerns-with-county-leader.html.

[7] Laurie Goldman et al, "Creative Uses of Eminent Domain-Implications for PLS Trusts", Amherst Mortgage Insight, Amherst Securities Group, June 28, 2012.

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