A Federalist Blessing in Disguise: From National Inaction to Local Action on Underwater Mortgages

Robert C. Hockett
Cornell Law School, rch37@cornell.edu

John Vlahoplus
Mortgage Resolution Partners

Follow this and additional works at: http://scholarship.law.cornell.edu/facpub
Part of the Property Law and Real Estate Commons, and the Securities Law Commons

Recommended Citation
http://scholarship.law.cornell.edu/facpub/605

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.
A Federalist Blessing in Disguise: From National Inaction to Local Action on Underwater Mortgages

Robert Hockett* & John Vlahoplus**

I. INTRODUCTION

The Great Recession that began with collapsing U.S. home prices in 2006 left American households with stunning negative home equity—an extraordinary excess of mortgage debt liabilities over home values. This debt overhang, which has remained as high as $700 billion through the year 2012,1 is the principal impediment to local and national macroeconomic recovery.2 Experts and lay people alike recognize that we must deal with the negative-equity crisis in order to repair our communities and restart our economy.3

What seems to be less widely recognized, however, is just how concentrated the crisis is both in certain geographic areas of the country and among

* Professor of Law, Cornell University; Consulting Counsel, International Monetary Fund; Fellow, The Century Foundation. Prof. Hockett has advocated the use of eminent domain to purchase and repair troubled mortgage-related financial assets since 2008, has served as consultant to local, state, and federal instrumentalities considering such use, and has since 2012 advocated use of eminent domain for privately securitized underwater mortgage loans in parallel with the second author, his friend since both authors’ tenures as Rhodes Scholars at Oxford University. Prof. Hockett also has been paid on one occasion, early in 2012, for consulting done for the second author’s firm.

** Founder and Chief Strategy Officer, Mortgage Resolution Partners LLC (MRP). MRP is a community advisory firm and the leading advisor to municipalities using or contemplating the use of eminent domain to purchase privately securitized mortgage loans, and is a for profit entity. The second author therefore has a direct financial interest in the outcome of the policy matters discussed in this essay.


3 See infra Part II.D.
certain toxic loans disproportionately originated there—and how these factors might account for the ineffectiveness of federal responses to date. Pre-dominately local problems are less likely to receive adequate attention from higher levels of government. Fortunately, they are apt to be taken with adequate seriousness by local authorities. Under our federal system of government, local governments have both the incentive and the authority to mitigate the negative-equity crisis, which will ultimately promote both local and national interests.

This essay describes the national and local impacts of the negative-equity crisis, the role that particular types of mortgage loans play in the crisis, the reasons for policy failures to date, and a solution that many local governments are considering to solve the problem locally—namely, using their powers of eminent domain to purchase toxic mortgage loans owed-on by local borrowers, then reducing principal to keep families in their homes and mitigate the economic and social costs of negative equity.

II. SIZING THE PROBLEM: NATIONAL TRAGEDY, LOCAL CALAMITY

A. National Effects

Over six years have passed since the latest residential-real-estate bubble burst, bringing unprecedented financial turmoil and a macroeconomic slump that continues to this day. Housing prices dropped nationally by thirty-five percent in the years 2005–09. Although home values fell, the fixed-mortgage debt obligations incurred by millions of American homeowners during the bubble years did not. In consequence, well over ten million mortgaged homes nationwide are now “underwater” (having a market value lower than the debts they secure), and millions of those loans are seriously delinquent, meaning the crisis is far from over.

Negative equity imposes dramatic costs even prior to or absent a loan default. Homeowners with negative equity spend significantly less on property maintenance because they do not consider themselves to be real owners. As noted above, they also spend less on consumer goods and services, thereby dragging down macroeconomic growth and employment, and, in so
doing, imperiling the solvency of other mortgagors too. The inability of
American borrowers with negative equity to refinance to lower current inter-

est rates is estimated to have cost the American economy ninety billion dol-

ars per year in lost disposable income. Negative equity and the threat of
resulting foreclosure also impose significant social-welfare costs, including

increased costs for physical and mental health care. Turning from non-default-related to default-related costs, negative equity is generally considered to be the single greatest predictor of loan def-

ault, which of course leads to additional costs. Expected default rates are as high as seventy-five percent for loans that are forty percent underwater—

that is, loans that have a combined loan-to-value ratio (CLTV) of 140%. In

states like California, a postdefault foreclosure or short sale (a sale at less

than the balance due, approved in advance by the lender) reduces the Prop-

osition 13—assessment cap to the forced sale price, significantly reducing

property-tax revenues for the foreseeable future. Foreclosures and short

sales also typically lead to disproportionate numbers of investment

purchases, which turn owner-occupied neighborhoods (particularly in com-

munities of color) into transient rental areas, imposing significant additional

social and economic costs on the community. It is unsurprising, then, that

See, e.g., Fed. Reserve Bd., supra note 2, at 3; see also Hockett, It Takes a Village, supra note 2; Robert Hockett, Recursive Collective Action Problems (Mar. 26, 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239849 [hereinafter Hockett, Recursive Collective Action Problems]; Robert Hockett, Six Years on and Still Counting: Sifting Through the Mortgage Mess, 9 Hastings Bus. L.J. (forthcoming 2013) (manuscript at 1) [hereinafter Hockett, Six Years]; Dudley, supra note 2. Note also that even the dismal consumer spending and growth numbers we have are skewed upward owing to the “shadow stimulus” produced by the twenty-four- to thirty-six-month period necessary to complete foreclosure and eviction in connection with defaulted mortgage loans. For each homeewan who is ultimately evicted, the period in question represents a period free of hous-

ing costs—costs that resume after eviction, diverting that much more away from would-be consumer spending.

10 See Alan Boyce, Streamlined Refinance and Other Ideas to Improve the Mortgage Mar-


11 See Craig Pollack, When Dreams Are Destroyed by the Foreclosure Crisis, Health Suf-


human-capital-blog/2011/10/when-dreams-are-destroyed-by-the-foreclosure-crisis-health-suf-

fers-too.html.

12 See Frank T. Pallotta, Eminent Domain Is No Solution to Negative Equity Problem, Am. Banker (July 18, 2012, 8:00 AM), http://www.americanbanker.com/bankthink/eminent-domain-is-no-solution-to-negative-equity-1050989-1.html; see also Laurie S. Goodman, Roger Ashworth, Brian Landy & Ke Yin, Negative Equity Trumps Unemployment in Predicting De-

faults, J. Fixed Income, Spring 2010, at 67–72; Stan Liebowitz, New Evidence on the Foreclo-

sure Crisis: Zero Money Down, Not Subprime Loans, Led to the Mortgage Meltdown, Wall

St. J. (July 3, 2009), http://online.wsj.com/article/SB124657539489189043.html (calling nega-

tive equity the single greatest cause of foreclosure).

13 Negative Equity: Stage One of Distressed Real Estate Inventory, Pro Teck Valuation

Services (July 19, 2012), http://www.proteckservices.com/hvf-lessons-from-the-data/na-

gative-equity-stage-one-of-distressed-real-estate-inventory/.

14 See David Garcia, What Can Be Done to Stop Absentee Landlords, STOCKTON CITY LIMITS (Dec. 4, 2012), http://stocktoncitylimits.com/2012/12/04/what-can-be-done-to-stop-ab-

Snapped Up by Outside Investors, OAKLAND LOC. (June 29, 2012, 11:57 PM), http://oakland
the Department of Housing and Urban Development finds that every fore-
closure can cost the homeowner, nearby neighbors, and the local govern-
ment as much as $44,000 in the form of reduced property values, transaction
and moving costs, and the utilization of otherwise-unnecessary government
services. Lenders compound these costs by generally refusing to allow
borrowers to rent back their homes after losing them in a foreclosure or a
short sale, for fears that these transactions will not be arm’s length and will
encourage moral hazard.

As a direct consequence of high levels of negative equity across the
nation, then, America’s hard-hit cities will continue to struggle with massive
economic and social costs until governments take effective action. In order
to protect their citizens, governments must directly and proactively reduce
negative equity rather than accept a continuing economic drag and further
costs from inevitable further defaults. It is the loans that are toxic, not the
homes or the borrowers.

B. Local Concentration

Although the mortgage debt crisis is crippling our entire nation’s econ-
yomy, it is crucial to understand that the worst of the problem is remarkably
localized in character. Although, as noted earlier, housing prices dropped
nationally by thirty-five percent in the years 2006–09, prices at the end of
2012 in the hardest-hit local neighborhoods were more than seventy-five
percent lower than their bubble peaks. As a result, there are some neigh-
borhoods in which more than eighty percent of mortgage loans are underwa-
ter. The degree to which the affected loans are underwater—or the

See Dep’t of Hous. & Urban Dev., Economic Impact Analysis of the FHA Refi-
nancenegativeequity.pdf (using HUD’s citation of the Joint Committee calculation of local-
government costs).

See, e.g., Brian Bean & Tim Hardin, Short Sale Lease-Back Program Ramps Up,
20121005-short-sale-lease-back-program-ramps-up.ece; Loren Berlin, Selling Homeowners
Short; Bank Strategy Backfires in Foreclosure Crisis, Huffington Post (Jan. 20, 2012,1:28
PM), http://www.huffingtonpost.com/2012/01/20/foreclosure-short-sale-homeowners_n_121
7200.html (noting that recent changes permit some lease-backs, but under extremely limited
conditions including purchase by a not for profit and borrower financial distress); Jason
com/jasonopland/blog/short-sales/short-sale-lease-back-program.

On page one, the HUD Report concludes that failing to prevent only one million fore-
closures would create a net cost of twenty-four billion dollars. HUD Report, supra note 15, at
1.

See National Historic Data HPI, CoreLogic (Feb. 2013), http://www.corelogic.com/

See infra chart accompanying note 24 (zip code–level data provided for zip codes
89030 and 89910).

See infra chart accompanying note 24 (zip code–level data provided for zip codes
30274, 30296, and 30297).
quantum of “negative equity”—is nothing short of astonishing: there are communities with significant percentages of loans with CLTV ratios (the ratio of total mortgage debt to home value) greater than 200%.

County-level effects. Plummeting home prices have left significant percentages of homeowners underwater, but the effects are not distributed evenly across the nation. Negative equity is concentrated in particular counties, as shown in the following map:

Zip code–level effects. Focusing even more locally on neighborhoods at the zip code level shows that the negative-equity crisis is even more concentrated in hard-hit neighborhoods. The following map shows the zip codes with the most foreclosures in 2012. They are highly concentrated in and around Atlanta, Chicago, Detroit, eastern coastal Florida, Las Vegas, the Los Angeles exurbs, Phoenix, and the Sacramento/Stockton/Vallejo region northeast of San Francisco.

---

21 See infra chart accompanying note 24.
23 Foreclosures: 100 Hardest Hit Zip Codes, CNNMONEY, http://money.cnn.com/interactive/real-estate/foreclosure-rates2013/ (last visited May 20, 2013). This graphic is based on data gathered by RealtyTrac LLC.
To understand the depth of the local problems in some of these areas, consider the following chart, which provides a sample of zip codes with the percentage of underwater mortgages and the percentage housing-price decline from peak through the end of 2012:

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City</th>
<th>State</th>
<th>% Underwater</th>
<th>% Price Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>92301</td>
<td>Adelanto</td>
<td>CA</td>
<td>64%</td>
<td>-70%</td>
</tr>
<tr>
<td>93501</td>
<td>Mojave</td>
<td>CA</td>
<td>65%</td>
<td>-71%</td>
</tr>
<tr>
<td>93505</td>
<td>California City</td>
<td>CA</td>
<td>72%</td>
<td>-71%</td>
</tr>
<tr>
<td>33035</td>
<td>Homestead</td>
<td>FL</td>
<td>68%</td>
<td>-69%</td>
</tr>
<tr>
<td>33127</td>
<td>Miami</td>
<td>FL</td>
<td>57%</td>
<td>-70%</td>
</tr>
<tr>
<td>33142</td>
<td>Miami</td>
<td>FL</td>
<td>62%</td>
<td>-66%</td>
</tr>
<tr>
<td>30274</td>
<td>Riverdale</td>
<td>GA</td>
<td>85%</td>
<td>-71%</td>
</tr>
<tr>
<td>30296</td>
<td>Riverdale</td>
<td>GA</td>
<td>84%</td>
<td>-66%</td>
</tr>
<tr>
<td>30297</td>
<td>Forest Park</td>
<td>GA</td>
<td>81%</td>
<td>-72%</td>
</tr>
<tr>
<td>89030</td>
<td>North Las Vegas</td>
<td>NV</td>
<td>77%</td>
<td>-76%</td>
</tr>
<tr>
<td>89101</td>
<td>Las Vegas</td>
<td>NV</td>
<td>75%</td>
<td>-76%</td>
</tr>
<tr>
<td>89106</td>
<td>Las Vegas</td>
<td>NV</td>
<td>72%</td>
<td>-71%</td>
</tr>
<tr>
<td>89115</td>
<td>Las Vegas</td>
<td>NV</td>
<td>77%</td>
<td>-72%</td>
</tr>
</tbody>
</table>

The degree to which homes are underwater in these neighborhoods is astonishing. The vast majority of the underwater loans in these zip codes have CLTVs near or in excess of 200%. In this context, remember that, as noted earlier, estimated default rates for loans of “only” 140% CLTV are as high as seventy-five percent.25 The toxic loans in these communities are not

---

24 See US Housing Crisis—Negative Equity Infographic, Zillow, http://www.zillow.com/visuals/negative-equity/#4/39.98/-106.92 (last visited May 20, 2013) [hereinafter Negative Equity Infographic]. There are numerous sources of data for home prices and negative equity. The authors use Zillow data extensively because the data is available online without charge. Readers may check the data and conduct further research into neighborhoods of interest without cost.

25 See Negative Equity: Stage One of Distressed Real Estate Inventory, supra note 13.
just underwater—they are in the deep end. Some sample CLTV distributions of underwater loans from zip codes in the chart above follow.26

**Distributions of Combined Loan-to-Value Ratios of Underwater Loans by Zip Code:**

![Chart showing CLTV distributions for CA 93501, GA 30296, and NV 89030.]

CLTVs of this magnitude are immensely harmful to communities. Neighbors lose their homes and cities lose property tax base. To make matters worse, the same development that drains off those public revenues—the abandonment of homes—also raises municipal abatement costs.27 Remaining homeowners accordingly not only find growing numbers of blighted homes springing up around them, but also find city and school services cut and local business losing revenue. The aggregate monetized loss wrought by such developments is now estimated at $2 trillion nationwide, and this is, again, a loss that is locally concentrated.28 There is little surprise, then, in the growing numbers of bankruptcy among municipalities at the core of the nation’s bubble and bust.29

**C. Role of PLS Loans**

*Centrality of PLS loans.* Just as important as geographic concentration in the nation’s ongoing mortgage mess is the concentration of certain types of toxic mortgage loans. The loans in question are those originated to pool into trusts, securitize, and then sell off to investors throughout the world without any government guarantee. These are the loans bundled in so-called “private-label securitizations” (PLSs). The types of loans originated for PLSs, their concentration in certain “boom” communities, and a number of serious practical and legal limitations on the operations of PLS trusts have placed PLS loans at the core of the housing crisis. The Federal Housing

---

26 See Negative Equity Infographic, supra note 24.
Finance Agency (FHFA) notes that these loans have represented over sixty percent of problem loans throughout the crisis and concludes that PLS loans "represent the crux . . . of the problem we face in foreclosure prevention. If we are going to stabilize the housing market, we have to address" those loans.30 Why are these loans the crux of the national housing crisis?

PLS loans were typically originated for borrowers with lower credit ratings (such as subprime or low-documentation loans) or lower income levels (such as option adjustable-rate or interest-only loans, which offer low initial monthly payments that later rise). These loans increased the pool of available purchasers and thereby increased demand and housing prices, particularly in boom areas with disproportionate Latino and African American populations.31 Areas with the greatest amount of PLS loan originations also saw the greatest price appreciation during the boom and the greatest price depreciation during the subsequent bust,32 driven by the spiral of economic downturn, income reductions, unemployment, inability to refinance or sell mortgaged homes at the principal balance due, and resulting foreclosures and short sales that further exacerbated the same factors.

Structural infirmities in PLSs.33 PLSs also suffer structural defects that limit the ability of the trust to modify or otherwise deal with underwater loans the way that a traditional bank lender can (and often does) with loans in its own portfolio.

A small number of banks and other institutions service the millions of underwater PLS loans on behalf of the ultimate trust investors. These servicers are overwhelmed and ill equipped to handle the unprecedented volume of bad loans. Many of the pooling and servicing agreements (PSAs) pursuant to which most loans are securitized prohibit or otherwise prevent the trustee or loan servicer from modifying or selling underwater loans in sufficient number. The same agreements typically require unanimity or supermajority voting among holders of mortgage-backed securities (MBSs) in order to change these rules, which in any event would be severely limited by income-tax-law limitations on trust activities.

Second liens also play a prominent role in our mortgage dysfunction story. The problem these present is that, unless they are modified along with

31 See, e.g., DR. RAUL HINOJOSA OJEDA, THE CONTINUING HOME FORECLOSURE TSUNAMI: DISPROPORTIONATE IMPACTS ON BLACK AND LATINO COMMUNITIES 2 (2009). It should be noted that this disproportionate targeting of African American and Latino communities highlights concerns raised by many that a perverse form of “reverse redlining” fueled much of the boom in “the boom years.”
33 For further discussion of these structural infirmities, see generally Hockett, It Takes a Village, supra note 2; Hockett, Six Years, supra note 9.
first liens, first lienholders lack incentive to modify.\textsuperscript{34} But second lienholders themselves lack incentive to modify owing to the “liquidity power” they hold over mortgagors, whose second liens often secure Home Equity Lines of Credit (HELOCs) to which they need access when financially strapped as they are now post-bust. Moreover, often the second lienholders are banks—banks that service the first-lien-secured loans themselves. This of course constitutes a significant conflict of interest standing in the way of constructive agreement among creditors. In short, then, communities and local borrowers are forced to bear the costs of negative equity as first- and second-mortgage owners in effect act jointly as holdouts.\textsuperscript{35}

The securitization structure as we presently find it and have just described it simply cannot operate properly in this crisis. Government intervention is required to protect not just the community but also all parties to the mortgage market, including investors.\textsuperscript{36} As a representative of the American Securitization Forum (ASF), an industry trade group, has stated before Congress:

Ultimately, it must be recognized that the seismic economic challenges in the United States, the epicenter of which is the housing market, are too great for purely private sector loan modification solutions . . . . Although industry-driven loan modification and loss mitigation actions have been and will continue to be key components to preventing avoidable foreclosures, there are limits to their effectiveness in addressing the extraordinary challenges in the housing market. As such, we believe expanded government programs may be effective in bridging this gap, and helping to address the potential foreclosures that commercial and contractual arrangements cannot prevent. The nationwide home price correction and persistent uptick in foreclosures present systemic risks to the national economic infrastructure. Moreover, foreclosures are bad for everyone—borrowers, communities and investors.\textsuperscript{37}


\textsuperscript{36} See Private Sector Cooperation with Mortgage Modifications—Ensuring That Investors, Servicers, and Lenders Provide Real Help for Troubled Homeowners: Hearing Before the H. Comm. on Fin. Services, 110th Cong. 21–23 (2008) (testimony of Tom Deutsch, Deputy Exec. Dir. Am. Securitization Forum); see also Hockett, It Takes a Village, supra note 2 (manuscript at 18) (“The fragmentation of ownership interests both in pools of mortgage loans and, thereby, even the individual mortgage loans themselves, renders it impossible for creditors to act in concert to modify underlying loans.”).

\textsuperscript{37} Deutsch, supra note 36, at 4.
How can governments help themselves and everyone else at the same time, in keeping with what the ASF has called for? Experts agree—write down principal on mortgage debt.

D. Principal Write-Downs

Virtually every major economist, federal regulator, and economic organization agrees that reducing principal on loans is critical to solving the negative-equity crisis and restarting the economy. These include Martin S. Feldstein, former Chairman of the Council of Economic Advisers under President Reagan: “To halt the fall in house prices, the government should reduce mortgage principal when it exceeds 110 percent of the home value.” 38 This approach would be consistent with the actions of Iceland, which recovered quickly from its housing bubble by offering principal reduction on every loan that exceeded 110% of the value of the house and by reducing principal on loans denominated in foreign currencies in proportion to the devaluation of the local currency. 39

Others pressing for principal reduction include the International Monetary Fund, which the United States relies on to enforce sound financial and monetary policies throughout the world; 40 Ben Bernanke, Chairman of the Federal Reserve Board of Governors; 41 Alan Blinder, former Vice Chairman of the same; 42 and Neil Barofsky, former Special Inspector General for the Troubled Asset Relief Program (TARP). 43

The conservative policy group American Action Forum also has summarized the problem and solution quite well:

The person who owes $450,000 on a house that is currently worth $300,000 is almost assuredly never going to pay the full amount he owes; eventually, he will either be granted a loan modification

to reduce the principal or else he will walk away—no matter how much we try to shame him into “doing the right thing.” The cost of walking away in most states amounts to little more than the inability to buy another house in the next five years . . . . Ultimately, America has a choice: Do we continue to insist that the people who made bad bets in the housing market get punished . . . or do we focus on creating policies that have the best chance of ending our economic malaise?44

It is, then, widely appreciated that principal write-downs will have to be done on a broad swath of underwater mortgage loans. Debt loss must be formally recognized in a manner commensurate with the devaluation of loan collateral—the homes that secure the home loans. Current efforts to address the problem by reducing interest rates or extending the terms of loans simply do not work—it’s the debt overhang that’s the thing.

Reducing the interest rate and extending the term of a loan can reduce the borrower’s monthly payment, which yields some benefit by increasing disposable income. However, it leaves the borrower underwater and therefore still at high risk of default. The evidence from existing loan modifications demonstrates this. Loan modifications that reduce principal outperform those that reduce interest rates or extend terms, and the greater the principal reduction the greater the outperformance.45 In addition, banks already write down principal on loans that they hold in their own portfolios at significant rates because it is in their own economic interest to do so in order to prevent losses from unnecessary defaults.46

Why then has principal reduction not yet occurred broadly for PLS loans, and how can governments, particularly hard-hit local governments, ensure that it does before it’s too late?

III. IMPEDIMENTS AND SOLUTION: A FIXABLE FAILURE OF FEDERALISM

Governments have failed to curb the negative-equity crisis to date for three main reasons, each stemming from our federal system: conflicting national and local policy interests, the blocking powers of special-interest groups at the federal level, and federal preemption of local regulatory actions.

46 See Hockett, It Takes a Village, supra note 2; see also Hockett, Paying Paul, supra note 2, at 3; David Streitfeld, Big Banks Easing Terms on Loans Deemed as Risks, N.Y. TIMES (July 2, 2011), http://www.nytimes.com/2011/07/03/business/03loans.html.
A. Conflicting Policy Interests

In dealing with the Great Recession, the federal government focused its attention and funding on the national financial system, not local interests. One mortgage investor asked the Treasury Department at the time “why the government isn’t positioning itself to use more of its fiscal resources to help remediate problems for homeowners. The answer was that many representatives on the Hill didn’t feel it was their problem—that we had very serious pockets of problems concentrated in a few states.” There is, of course, no contradiction between such concentration and the national significance of the problem, but cities nevertheless experience the worst of things before federal instrumentalities do. Even after the Treasury Department promised Congress to use federal funding to buy loans out of trusts as part of a deal to save TARP, for example, Treasury used the funding instead to save the national banking system by making direct investments in banks, leaving the negative-equity crisis to grind on. Local governments with a more immediate interest in, but fewer resources available for, addressing the housing crisis were left behind.

In fairness to the federal government, national programs require a national policy focus. This is not often easy to come by in a crisis that affects different parts of the country differently. As the head of the FHFA has observed, a national policy for federally controlled mortgage companies, such as one to reduce principal, must be “clear and transparent, having a . . . general acceptance of reasonableness if not fairness. And it would have to be clearly and publicly described so that more than a thousand mortgage servicers could apply the rules the same way.” Principal reduction is “a particular concern for [Fannie Mae and Freddie Mac] because unlike other mortgage market participants that can pick and choose where principal forgiveness makes sense, the Enterprises must develop the program to be implemented by more than one thousand seller/servicers.” Local governments can of course pick and choose, implementing policy as they see fit locally without regard to different conditions and different policy goals in other parts of the country. They are accordingly better situated than the federal government to take the lead in addressing—and finally ending—the crisis.

50 Id. at 19.
A Federalist Blessing

B. Blocking Power

The need for national consensus to make national policy has impeded a federal solution that reduces principal. The federal government’s early, tentative, and limited attempt to reduce principal triggered the formation of the Tea Party,\textsuperscript{51} whose opposition both stalled subsequent federal efforts in the area and endangered other White House initiatives. With such power, some interest groups are able to block federal action, even where that action is of great interest to other stakeholders. Special-interest groups have also been able to block action at the state level. Proposed legislation in Arizona to implement principal reduction through the use of eminent domain was killed in committee by opposition from banking groups, for example.\textsuperscript{52} Failures to implement meaningful relief have left only voluntary federal programs in place, which rely for their implementation on the very mortgage industry that created the problem and has done nothing to solve it.

The Home Affordable Mortgage Program (HAMP), to begin with, does not prioritize write-downs (it was not meant to do so).\textsuperscript{53} What is more, on those rare occasions that parties do employ HAMP for this purpose, they do so by in effect bribing servicers—ironically, simply to induce them to do what is independently in the interest of those creditors they are meant to “serve.” Even apart from all of this, however, is the fact that HAMP offers no means at all of getting around the central obstacle upon which we are here focused—the contractual restrictions that PSAs place upon servicers whether they are bribed by federal money or not.\textsuperscript{54} What all of this means is that HAMP is simply not useful for the task with which we are here concerned, even granting the limited good it has done for some mortgages in connection with which underwater status is not the principal problem.

C. Federal Preemption

We have seen that the federal government has the funds to fix the crisis, but not the consensus or will to do so. Hard-hit local governments have the will, but not the funds. The problem is that municipalities finance their operations, overwhelmingly, out of property-tax revenues. And in the present context, of course, this means that the very challenges that call on them to spend their revenues—the underwater loans and attendant foreclosure and blight crises—also deny them their revenue base. And all this happens, as if


\textsuperscript{53} See Hockett, \textit{It Takes a Village}, supra note 2 (manuscript at 21–22); see also Hockett, \textit{Paying Paul}, supra note 2, at 4.

\textsuperscript{54} See Hockett, \textit{It Takes a Village}, supra note 2 (manuscript at 18–22); see also Hockett, \textit{Paying Paul}, supra note 2, at 3–4; Hockett, \textit{Six Years}, supra note 9 (manuscript at 20–21).
to compound the irony, precisely as abatement costs wrought by evictions are apt to rise.

As a result, cities have typically turned to their regulatory powers over real property to try to mitigate the costs of the crisis. These powers are limited, however, particularly by preemption of state laws governing lending and servicing. The nature of the federal system again works against the local governments.55

How, then, can municipalities act? How can it be politically feasible, and how can the cities set policy? How can they do so practically, given that they are even more cash strapped these days than the federal government?

IV. SEIZING THE INITIATIVE: THE MUNICIPAL PLAN

From 2008 through 2009, three legal academics, including one of the present authors, separately advocated federal purchases—voluntary and, where necessary, compulsory under eminent domain—of troubled mortgage loans and associated financial assets.56 By 2010, additional advocates, including a member of Congress, had joined the call.57 For several reasons, however—one of them probably being the earlier discussed local concentration of the problem—the federal government has yet to act on a scale matching the magnitude of the problem.

Yet cities can act, and doing so is actually quite simple. Under their own eminent domain authority, states and/or their municipalities can purchase underwater mortgage loans out of PLS trusts at fair value, thereby breaking through PSA contract rigidities to do what so many PSAs now prevent current holders (and their fiduciaries) themselves from doing—modifying loans and thus making them payable.58 Or for homeowners unable to afford even a lower principal balance, the cities can permit a short sale and...
rent back with an option to purchase, ensuring the family stays in the home and maintaining the neighborhood’s stability.

This would be consistent with the urgings of the ASF, which has called upon the federal government to solve the crisis by purchasing loans out of securitization trusts—something that can occur only through the use of eminent domain, because as noted before, the trusts cannot voluntarily sell the loans under their own PSAs and applicable tax laws:

TARP could purchase individual distressed loans out of MBS trusts, which could give the Treasury Department unlimited discretion to modify those loans. Historically, whole loans have not been sold out of securitization trusts by servicers for a variety of legal, tax, and accounting constraints. The ASF supports, where feasible, facilitating such purchases as part of a broader range of loss mitigation alternatives . . . .59

It would also be consistent with the urging of the Securities Industry and Financial Markets Association (SIFMA), whose head publicly urged the federal government to buy loans out of PLS trusts, stating:

Securitization is a critical engine of today’s economy, making available additional capital for borrowers. The recent turmoil has stalled large parts of this market and restarting it will help ensure consumers get the loans they need for homes . . . . I am disappointed Treasury is choosing to de-emphasize the asset purchase portion of the TARP program. Based on my experience with the Resolution Trust Corporation, I believe a key ingredient to a strong recovery is the creation of price discovery through some type of transparent purchase program.60

It also bears noting that eminent domain authority can be used to address a related problem noted above—one that many have found most intractable. Specifically, entities that use the eminent domain plan can compulsorily purchase second-lien-secured loans as well—or, if preferred, simply the liens that secure them—converting the loans to unsecured consumer debt. Even the prospect that this might be done should bring second lienholders to the table—including such as till now might have been acting as holdouts.

It should be kept in mind in considering the foregoing that the purpose of the program is not to bail out the borrower; the policy analysis does not depend on the morality of the borrower’s or the lender’s prior actions in taking or making a toxic mortgage loan. The purpose is to save the neighbor, the community, and the city itself from the evils of negative equity. To

59 Deutsch, supra note 36, at 9.
adapt the American Action Forum’s reasoning, “Ultimately, [local governments have] a choice: Do we continue to insist that the people who made bad bets in the housing market get punished . . . or do we focus on creating policies that have the best chance of ending our economic malaise?”

Each city must examine its own situation and make its own policy. This is consistent with the views of economists who see the need for locally tailored solutions, and it fits with the federal view that the problem is local. Lawrence Summers, former Treasury Secretary under President Clinton and former Economic Advisor to President Obama, has stated: “Surely there is a strong case for experimentation, with principal-reduction strategies at the local level.” Hal Varian, Chief Economist of Google, stated: “There are two different housing market problems, one due to excess supply the other due to insufficient demand . . . . Given the rather different circumstances of the two housing markets, it makes sense to write down mortgages differently based on local default conditions.”

Moreover, municipalities can tailor this plan to their local circumstances. They can, for example, adapt the plan to underwater condominiums if those constitute part or all of their underwater loan problems, or to duplex or single-family homes if these are the rub. Municipalities adopting the plan can, in other words, do something that FHFA says is desirable in explaining its own reticence about acting on a national scale: “[S]ome mortgage market participants can selectively offer principal forgiveness in cases tailored to their particular circumstances, objectives, and customers.”

Local action is also consistent with a growing movement to try new policy initiatives at the state or local level, including ones different from those pursued at the federal level. For example, many Republican-controlled states are experimenting with lowering taxes, or shifting from income taxes to consumption taxes, counter to federal income-tax increases. Their goal is to try to stimulate growth and be a catalyst for changing federal policy.

Successful local action on mortgage loans can be a similar catalyst for action at the federal level.

In addition, local action in California to permit residents to remain in their homes, either as owners with reduced principal or under a short sale and lease-back, would also further California state housing policy. California law makes first-mortgage loans legally or practically nonrecourse with

---

61 See Brannon, supra note 44.
the intent that lenders bear the risk of any decline in housing prices that eliminates the borrower’s equity. California enacted these overarching state laws after the Great Depression in order to eliminate the moral hazard of banks lending without sufficient underwriting and down payment, and to mitigate the downward spiral caused by borrower debt liability after a property crash. California enacted these overarching state laws after the Great Depression in order to eliminate the moral hazard of banks lending without sufficient underwriting and down payment, and to mitigate the downward spiral caused by borrower debt liability after a property crash.66 Lenders are subject to moral hazard in their actions just as much as borrowers are.

Yet lenders are relentlessly using all available tactics to shift that risk back to underwater borrowers, including shame, guilt, and concerted refusal to deal with (or permit others to deal with) borrowers in subsequent sales or lease-backs of the homes.67 Lenders refuse to acknowledge that their actions carry moral hazard, and that permitting them to evade the risk that California law places on them creates additional moral hazard. Purchasing the loans for fair value and then permitting the borrowers to remain in their homes ensures that lenders bear the risk that California law assigns to them, and that homeowners receive the benefit of the bargain that they made by taking out a nonrecourse mortgage loan.

The authors suggest that an effective policy requires localities to do the following: (a) target PLS loans, which is the most efficient use of resources and avoids federal preemption issues of dealing with loans under the ownership or conservatorship of the federal government; (b) take action that is not regulation, again in order to avoid preemption; (c) utilize existing legal powers to avoid the blocking power of special interests over new legislation at the state or federal level; (d) purchase local underwater mortgage loans and reduce principal directly, as some states are beginning to do rather than using their limited funds to pay lenders to write down uncollectible principal;68 and (e) use eminent domain to condemn loans from PLS trusts given that the trusts’ PSAs do not permit voluntary sales.

Two major questions come immediately to mind. Is it legal to condemn those loans? And is it practical? Fortunately, the answer to both questions is yes.

---

66 See, e.g., CAL. CIV. PROC. CODE § 580(b) (West 2007) (mandating nonrecourse purchase money loans); CAL. CIV. PROC. CODE § 726(a) (West 1992) (creating a single action rule that makes other mortgage loans nonrecourse in practical terms); Thomas N. Jacobson, The Purchase Money Dilemma, CAL. REAL PROP. J., Spring 2010, at 35, 35.

67 See, e.g., Brent T. White, Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis, 45 WAKE FOREST L. REV. 971, 997 (2010); Berlin, supra note 16 (detailing how banks require home buyers to promise not to rent back to the borrower).

A. Legality

A complete legal analysis of the proposed use of eminent domain is beyond the scope of this essay but available in other publications by one of the authors. In summary, however, the power of eminent domain applies to all manner of intangible assets. These include bond-tax-exemption covenants, contract rights, insurance policies, corporate equities, businesses as going concerns, hunting rights, rights of way, and sports franchises, among others. The Supreme Court and state courts have even recognized that the power extends to mortgage loans and liens in particular.

There is no real legal question, then, as to what species of property can be taken under the eminent domain power; for the answer is that the power extends to all forms of property. The only real question in eminent domain cases is whether the authority exercising the power exercises it for a bona fide public purpose and pays fair value for the property. Forestalling and reversing a continuing wave of destructive foreclosures, homelessness, blight, abatement cost rises, revenue loss, essential city service retrenchment, and likely municipal insolvency unsurprisingly constitutes one of the more compelling of eminent domain—justifying public purposes. Fair value is, of course, an issue of fact, so questions about value are merely hypothetical until trial (although discussed below). Disagreements about value cannot

69 See Hockett, It Takes a Village, supra note 2 (manuscript at 36–49); Hockett, Paying Paul, supra note 2, at 6–7.
75 See, e.g., Swan Lake Hunting Club v. United States, 381 F.2d 238 (5th Cir. 1967).
77 See, e.g., City of Oakland v. Oakland Raiders, 646 P.2d 835 (Cal. 1982).
78 See, e.g., Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 602 (1935) (“If the public interest requires . . . . the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain.”); W. Fertilizer & Cordage Co. v. City of Alliance, 504 N.W.2d 808, 816 (Neb. 1993) (holding that a mortgagee’s lien on real estate is an interest that may be subjected to a taking for a public purpose and, therefore, may be the subject of an eminent-domain proceeding).
79 See, e.g., Kelo v. City of New London, 545 U.S. 469 (2005). The Kelo decision makes for a particularly interesting comparison. There, the U.S. Supreme Court upheld a taking of actual homes at fair-market value from predominantly elderly residents with significant non-monetizable sentimental attachments to the homes, then conveyed them to Pfizer in the name of a particularly speculative claim that this would economically revitalize the city of New London, Connecticut. What is contemplated here, by contrast, is a taking of underwater mortgage loans with no sentimental significance at truly fair value, in the name of a much more plausible claim that this will, by addressing a market failure, bring value to bondholders, homeowners, and wider communities alike.
invalidate a proposed use of eminent domain, but merely set the stage for the ultimate price in negotiation or litigation.

Opponents of the proposed use of eminent domain (including the ASF and SIFMA, which have changed their tune now that governments actually propose to follow their advice) have commissioned legal memoranda raising issues with the proposal’s legal justification. However, both practicing lawyers and legal academics have repeatedly and publicly rebutted these memos.80 In addition, the authors of this essay are in regular conversation with municipal governments across the nation, and none has found any of the opponents’ legal arguments to have any merit. Each government must conduct its own analysis, of course, just as it does with the exercise of any of its powers. But none should treat these memoranda as a reason not to consider the program.

B. Practicality: Pricing and Purchasing Loans

The next concern is whether the use of eminent domain is practical given the funding required to purchase loans and the scarcity of local resources. There is a perception that writing down principal costs money. As one economist writes, “A more dramatic and costly policy step, but one with the best odds of ending the housing crash quickly and definitively, would have the government facilitate loan modifications with substantial principal write-downs.”81

Fortunately, it is economically practical to implement the program because (a) the losses on underwater loans have already occurred; (b) properly underwritten loan acquisitions and principal reductions can increase the value of the loans, making rather than costing money; and (c) private funding is available to pay for and take the risks of the condemned loans.

Losses have already occurred. Underwater mortgage loans are simply financial assets, which financial institutions regularly trade and value. The collapse of housing prices caused losses on the loans; these losses have already occurred, and the markets provide regular evidence of this. For example, the FDIC recently sold a pool of 1100 underwater mortgage loans, of which eighty percent were current and only twenty percent delinquent, for

---

forty-three percent of unpaid principal balance. As another example, Fannie Mae publishes the fair value of its investments in PLS securities, which reflect the fair value of the loans within the PLS trusts, and recently carried many of its investments at approximately half of the unpaid principal balance.

The reason for this pricing is clear. The default rates on underwater loans are so high, and the amounts recovered after a default so low, that the expected values of the loans are significantly lower than face value. In a simple example, if a loan has a seventy-five percent chance of default, upon which the holder would collect only twenty percent of face value, and a twenty-five percent chance of collecting 100% of face value, the simple weighted-average value of the loan is only forty percent of face value, similar to the recent FDIC sale.

**Value creation.** Next, reducing principal can actually increase the value of a loan by reducing the likelihood of default. The FHFA has made this very clear in its own analysis of Fannie Mae’s and Freddie Mac’s portfolios of loans. The FHFA examined what would happen if Fannie and Freddie took every loan in their portfolios that exceeded a loan-to-value ratio of 115% and unilaterally wrote down principal to 115%—without even bothering to underwrite the borrowers.

The result was clear. This unilateral action would reduce Fannie’s and Freddie’s losses by twenty billion dollars (twenty percent of their loss reserves); if they also underwrote the borrowers, writing down principal to 115% would reduce losses by twenty-eight billion dollars (twenty-eight percent of their loss reserves). Principal reduction works for everyone, including borrowers, lenders, and local communities.

**Funding and risk mitigation.** Here too, a straightforward answer awaits our discovery: private money can finance the purchases and thus spare the public fisc because private investors already buy underwater loans and work them out as an ongoing business. They can provide the capital and services that cities require, helping the cities (a) select and preliminarily value the appropriate underwater loans, (b) secure funding, (c) commence and conduct the legal proceedings pursuant to which eminent-domain authority is actually exercised, (d) restructure the loans once they are purchased, and (e) work with homeowners in connection with the foregoing. Significant legal, financial, and counseling expertise are required if all of these functions are to be discharged effectively. Yet this can all of it be had and be done, as one

---


83 See FEDEL. NAT’L MORTG. ASS’N, QUARTERLY REPORT PURSUANT TO SECTION 13(d) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDING JUNE 30, 2012, at 41 tbl.23 (2012).

84 See Letter from Edward J. DeMarco to Elijah E. Cummings, *supra* note 34, at 19 (table of losses and loss mitigation).
of the authors has detailed elsewhere and as municipalities are already demonstrating.\footnote{See Hockett, \textit{It Takes a Village}, supra note 2 (manuscript at 28–35); \textit{supra} text accompanying note 64 (addressing the plan’s amenability to multiple variations tailored to specific—even idiosyncratic—local needs and conditions state-by-state or city-by-city).}

PSAs now harm the very people they were meant to protect—the bondholders—effectively now working as “suicide pacts.” They do this by preventing securities markets from doing what they ordinarily do best—repricing assets in light of changed asset values and thereby facilitating efficient sale and transfer. This is precisely where eminent domain enters into our story. It enables municipalities to sidestep, on behalf of private parties, those very market-paralyzing securitization contracts that private parties can’t sidestep, then refinance debt so that markets can once again do what they normally do best, which is to price goods efficiently and thereby recoup otherwise lost value. America’s hard-hit cities did not sign these suicide pacts, and they are not bound to suffer because of them.

\textbf{C. Practicality: Market Reaction}

Finally, will there be unintended consequences that make action impractical? Isn’t the market recovering on its own? Won’t lenders refuse to do business with communities that use eminent domain to acquire these loans?

Although there have been signs of home-price increases nationally, hard-hit localities that suffered such large price declines and have homes with CLTVs in the range of 200\% are highly unlikely to escape the negative-equity crisis from price appreciation alone. Multiple factors—including the temporary foreclosure moratoria to ensure proper filing of loan documentation, and the state attorneys’ general settlement with mortgage-loan servicers in 2012—have in recent years artificially held distressed-sale properties off of the market.\footnote{See, e.g., Blomquist, \textit{Chasing Shadow Inventory: Sloppy Foreclosures and Unintended Consequences}, 14 \textit{CITYSCAPE: J. PUB’N DEV. & RES.}, 171, 172–73 (2012), available at http://www.huduser.org/portal/periodicals/cityscpe/vol14num1/Cityscape_Mar2012_chasing_shadow.pdf; Brennan, \textit{How The $25 Billion Foreclosure Settlement Will Really Affect The Housing Market}, \textit{Forbes} (Feb. 9, 2012, 4:31 PM), http://www.forbes.com/sites/morganbrennan/2012/02/09/how-the-25-billion-foreclosure-settlement-will-really-affect-the-housing-market/.} As these factors retreat and backlogged inventory returns to an economy with continuing high unemployment, flat to falling incomes, and tight housing credit, prices are unlikely to rise dramatically over a long period, particularly in the local areas with the highest levels of negative equity.\footnote{See, e.g., Miller, \textit{Tight Credit Is Causing Housing Prices to Rise}, \textit{MATRIX} (Feb. 6, 2013, 9:18 AM), http://www.millersamuel.com/blog/tight-credit-is-causing-housing-prices-to-rise/28275.}

As for the claims about future credit flows, those who make these claims never explain how averting massive foreclosure costs, raising the expected values of currently default-prone assets, and paying fair value to PLS
trusts that cannot now market these toxic assets can ever truly reduce available capital—especially given that the capital in question flowed too abundantly, thanks to predatory subprime lending promoted by the securitization industry, prior to the bust.88 (Indeed, this excess credit just was the bubble that brought us the bust—and with it the harm that is now suffered by bilked investors, homeowners, and their communities alike.89) The only way in which credit might come to be unhealthily constrained, then, is if securitization industry groups conspiratorially boycott municipalities that work to mop up the mess they have left in the wake of the bubble they fueled, as some such groups shockingly have been threatening to do.90 These threats are not going to succeed in frightening off hard-hit cities, however, which have nothing left to lose after what this industry has already done to them. And the threats invite action, moreover, from the Department of Justice and from regulators under color of antitrust and consumer-credit law. Indeed, officials have already begun turning attention to these acts of would-be extortion.91 It would be hard to conceive a more broadly supported exercise, post-bubble-and-bust, of prosecutorial and regulatory authority than one invited by securitization industry “redlining” of cities now struggling precisely owing to “reverse redlining” by the boycotters themselves.

In fact, it would be impractical to do nothing and allow the negative-equity crisis to continue. None less than the International Monetary Fund has stated: “It would clearly help restart primary (new issuance) markets if some of the impaired ‘legacy securities’ could be cleared away . . . . There is still much work to be done in clearing away the legacy assets, and in this regard, public-private sector partnerships . . . are helpful.”92 New securitizations have occurred since the proposal to condemn loans first became public. The securitized loans have specifically warned of the risk factor, and have sold without a hitch.93 Markets are aware of the risk and are pricing it

88 The housing bubble was after all, like all bubbles, an overabundant credit-fueled asset-price bubble. See generally Hockett, It Takes a Village, supra note 2 (manuscript Parts I–II); Hockett, Recursive Collective Action Problems, supra note 9. For more on the financial and legal viability of the plan, see, for example, Reiss, supra note 80; Christopher Serkin, Democratic Government and Eminent Domain, in response to From Kelo With Love: Revisiting Kelo’s Flawed Economics and Vacuous Constitutionalism, ONLINE LBR. L. & LIBERTY (Nov. 4, 2012), http://libertylawsite.org/liberty-forum/democratic-government-and-eminent-domain/.
89 For further discussions, see again the observations adduced supra, note 85.
in, as they should, and as they will whether any government actually con-
demns loans or not.

V. CONCLUSION: IT TAKES A VILLAGE

We hope we have made the point plain. Although the underwater-mort-
gage-loan problem bears considerable national consequences, it remains at
its core a profoundly local problem tied to particular toxic loans originated
locally. This fact bears two salient consequences. One is that the problem’s
disproportionately local character poses some obstacle to federal authorities’
treating it with the seriousness that it warrants. The other is that the locali-
ties that have sufficient incentive to take the problem seriously, ironically,
lack sufficient resources to act—precisely because the problem in this case
strikes at local finances themselves by squeezing local property-tax bases.

The only way around this poignant double bind is for localities to use
private funds in addressing their problems. In this case that’s altogether fit-
ting. The localities will do what they do best—make local policy as the
government closest to the people—and at the same time will help private
enterprise do what it does best but cannot do now because of the limitations
of private securitizations.