



## **Eminent Domain Position Paper**

### **Background**

Local governments in several states recently have considered or are considering proposals to use their eminent domain powers to seize underwater mortgage loans from their owners, private securitization trusts acting on behalf numerous MBS investors, and refinance them with lower balance mortgage loans (such proposals, “Eminent Domain Proposals”). Under these Eminent Domain Proposals the new loans would be funded through government programs such as the Federal Housing Administration (“FHA”) loan program and the owner of a refinanced mortgage loan would receive compensation for the value of that loan in an amount that is anticipated to be less than the value of the property that secures the loan. The owner of the refinanced mortgage loan would suffer a loss roughly equal to the difference between the amount owed on the loan and the value of the loan determined through the eminent domain process, regardless of whether the loan was performing or the related borrower was in distress.

The characteristics of the Eminent Domain Proposals discussed in this position paper are based upon, but not limited to, the proposal developed and marketed by Mortgage Resolutions Partners LLC (“MRP”).

### **Our View**

The Structured Finance Industry Group (“SFIG”) is sympathetic to the difficulties faced by municipalities and borrowers adversely affected by the current condition of the housing market and the economy. However, SFIG strongly objects to any proposed use of eminent domain to seize underwater mortgage loans from private securitization trusts. For the reasons further explained below, SFIG believes that use of eminent domain by local municipalities to seize underwater mortgage loans in private securitization trusts will harm the housing market and future borrowers in those municipalities, and pensioners across the country, as well as state and local pension plans, 401(k) plans and IRAs, college savings plans, insurance companies, mutual funds, university and hospital endowments, and government-sponsored enterprises.

Also, SFIG believes that because the Eminent Domain Proposals target mortgage loans held by private securitizations trusts, the return of private capital to the residential mortgage market will

be impeded as investors will view the private-label MBS market as too risky due to unpredictable and costly government interventions.

Finally, SFIG believes that the Eminent Domain Proposals violate rights to private property and contract established under the U.S. Constitution and various state constitutions and statutes. Municipalities that adopt Eminent Domain Proposals will face a substantial risk of legal challenge to their implementation by aggrieved MBS investors, asset managers with fiduciary duties and other obligations to MBS investors, or other interested parties.

### **The Eminent Domain Proposals Will Have Adverse Consequences for Residents of Adopting Municipalities**

Homeowners in municipalities that seize loans through eminent domain will likely face a higher cost of mortgage credit due to a lender's increased risk of loss, a lack of legal certainty, and reduced liquidity for local mortgage loans. Proponents of Eminent Domain Proposals tend to focus on the benefit to be gained by homeowners in local communities who will essentially receive a significant principal reduction with respect to their current mortgage obligations. However, a city that seizes mortgage loans for the benefit of a few of its residents will cause a substantial financial harm to the many other homeowners in the community. Lenders and investors in mortgage loans in such municipalities will have to build into their credit risk analysis the material and unquantifiable risk of loss that will result from having their mortgage assets seized through eminent domain. Therefore, residents in these communities who have paid or continue to pay their current mortgage obligations and whose loans are not subject to seizure will not receive the obvious and immediate benefit of the Eminent Domain Proposal but will be directly and significantly impacted by having their future mortgage needs subject to higher costs and decreased availability. Accordingly, the Eminent Domain Proposals are inherently unfair to residents of an adopting municipality whose mortgage loans are not subject to seizure and residents outside the adopting municipality's borders.

A substantially greater tightening of credit would occur if the Federal Housing Finance Agency ("FHFA"), the conservator of Fannie Mae and Freddie Mac and the regulator of the Federal Home Loan Banks decides to take action in response to the Eminent Domain Proposals. On August 8, 2013, FHFA publicly released a statement to the following effect:

"In response to an eminent domain action to restructure mortgage loans, FHFA may take any of the following steps: initiate legal challenges to any local or state action that sanctions the use of eminent domain to restructure mortgage loan contracts that affect FHFA's regulated entities; act by order or by regulation to direct the regulated entities to limit, restrict or cease business activities within the jurisdiction of any state or local authority employing eminent domain to restructure mortgage loan contracts; or take such other actions as may be appropriate to respond to market uncertainty or increased costs created by any movement to put in place such programs."

Any such action by the FHFA would increase the cost and decrease the availability of mortgage credit in the community, further depress home prices and exacerbate the very conditions that the municipal leaders are trying to address.

In addition, a significant impact is assured since mortgage loans from a jurisdiction that has implemented an Eminent Domain Proposal are not eligible for delivery into TBA-eligible securities (SIFMA Statement on Eminent Domain and TBA Trading, July 19, 2012).

### **The Eminent Domain Proposals Violate Rights to Private Property and Contract Established under the U.S. Constitution and Various State Constitutions and Statutes**

Under the Fifth Amendment of the U.S. Constitution, the power of eminent domain can only be exercised to take private property when the proposed taking is for a public use and benefit and when just compensation is provided to the owner of the property. Similarly, judicial interpretations of the Contract Clause of the U.S. Constitution (Article I, § 10) require that any action by a state or local government that substantially impairs a contractual relationship have a significant and legitimate public purpose. The Eminent Domain Proposals fail to satisfy either the public use/purpose requirement or the just compensation requirement.

The Eminent Domain Proposals directly and primarily benefit a limited number of borrowers, those whose loans are owned by private securitization trusts and meet the prescribed credit criteria, as well as the sponsors of the Eminent Domain Proposals who earn fees and investment income from their implementation. Any public use and benefit realized from the seizure of loans under the Eminent Domain Proposals is merely incidental to the benefit provided to individual borrowers. Any benefit to the community from reduction in the loan balances of the limited number of eligible borrowers would result incidentally from the ability of those borrowers to meet their personal financial obligations. That incidental benefit would come at the risk and expense of other borrowers in the community who would bear the risk and expense of more restrictive mortgage credit resulting from the enactment of the Eminent Domain Proposal and the investors who owned interests in the seized mortgage loans, including all persons, within and outside the community, whose retirement and other savings are invested in the affected MBS.

While the historical and accepted use of the eminent domain power has been to seize physical property within the municipality for a direct public benefit, such as construction of a new road or construction of public facilities, the Eminent Domain Proposals posit the seizure of a loan – instead of physical property located within the community.

Nor do the Eminent Domain Proposals provide for just compensation for the seized mortgage loans. The Eminent Domain Proposals assume that the value of a seized mortgage loan is an amount that is determined based upon a significant discount to the fair value of the home securing the mortgage loan, not the value of the seized mortgage loan. This assumption is fatally flawed as the value of the mortgage loans that would be seized are likely worth an amount much

closer to the net present value of the outstanding payments owed on those loans—not the current value of the homes pledged to secure those loans.

Additionally, the Contracts Clause was incorporated into the U.S. Constitution by the framers to bar states from nullifying the debts of their residents at the cost of foreign investors. It is unimaginable that the framers of the U.S. Constitution would take a completely different view if faced with the obvious consequence of a locality's adoption of MRP's Eminent Domain Proposal – forgiving a significant portion of the mortgage debt owed by its residents to lenders and investors outside of its borders.

The Eminent Domain Proposals also violate provisions of many state constitutions and statutes. We note in particular that the mortgage loans targeted for seizure under the Eminent Domain Proposals are evidenced by notes that are not generally held by parties located in the municipalities that would seize them. In many instances municipalities lack authority under state law to implement Eminent Domain Proposals because they do not have the authority to seize property located in another state.

SFIG believes that any municipality considering Eminent Domain Proposals should recognize the legal flaws in their design and the real and substantial risk of litigation challenging their implementation or the values assigned to the mortgage loans seized under them.

**Borrowers who have had their mortgages seized and reduced could face unanticipated tax liabilities that increase their risk of default.**

Borrowers in adopting municipalities who receive the benefit of an Eminent Domain Proposal may be subject to a taxable event following the seizure and refinance of their mortgage loans as a result of principal forgiveness. If these residents do not qualify for relief under the Mortgage Relief Act of 2007 as currently written or, if they do qualify, the Mortgage Relief Act of 2007 is not extended beyond 2013, they may be subject to significant unanticipated taxes on the principal forgiven on their loans. Absent a specific exemption or some other tax relief from the federal government, many may be at a higher risk following the origination of the new mortgage loan due to these unanticipated taxes. Borrowers may also have unanticipated state tax liabilities on forgiven principal that further exacerbate this risk of default. In addition, the tax implications of an Eminent Domain Proposal may be considered by an underwriter in connection with the origination of the new loan which may increase the cost of the new loan or make certain of these borrowers ineligible.

**A city that seizes loans through Eminent Domain will cause losses to the pensions and savings accounts of ordinary Americans across the country.**

Forcibly seizing mortgage loans from securitization trusts through the use of eminent domain would cause financial harm to the investors in such securitization trusts who reside outside of the municipality adopting the Eminent Domain Proposal for the benefit of the residents of the

adopting municipality whose mortgage loans are seized and, in the case of the MRP Eminent Domain Proposal, MRP. For example, a teacher in Texas or a pipefitter in Kentucky could see his or her pension fund suffer a loss as a result of the eminent domain actions of a city in California or any other state. The success of the Eminent Domain Proposals is predicated on the adopting municipality seizing a loan from a securitization trust at a cost which represents a significant discount to the unpaid principal balance of the loan seized and future payments of interest thereon plus, in the case of the MRP Eminent Domain Proposal, the fee required by MRP to “assist” with the implementation thereof. Clearly there is an inherent unfairness with the notion that the actions of a local municipality would reach outside of its borders and cause irreparable harm to residents of other states and municipalities, but this is precisely the effect of the adoption of the Eminent Domain Proposals.

The seizure would result in huge losses to MBS investors and, in turn, the savings and retirement accounts they manage. MBS investors manage the investments of countless Americans through 401 (k) plans, mutual funds, individual investments and other investment tools, as well as state and federal employee pension plans. These investment instruments would significantly decline in value and, although the properties seized through eminent domain would represent a small geographic location, substantial financial harm would be inflicted on retirees, firefighters, teachers, law enforcement personnel, and other ordinary working Americans across the country.

Moreover, the tax rules are unclear as to whether a seizure of performing or reperforming mortgage loans at a discount from a securitization trust structured as a REMIC could jeopardize its status as a REMIC resulting in tax liability. Seizures of performing or reperforming mortgage loans at discounts from REITs may be problematic from a tax perspective for REITs as well. Any taxes imposed on a REMIC or a REIT would be borne by their respective securityholders, another financial loss to the ordinary working Americans whose pensions and savings accounts hold these investments. Guidance from the Internal Revenue Service should be obtained so that the risks can be quantified before municipalities consider seizing mortgage loans through eminent domain.

### **Eminent Domain Proposals Impede the Return of Private Capital to the Residential Mortgage Market**

For several years it has been a stated goal of the Administration and many members of Congress to increase the role of private capital in funding our housing finance market and absorbing mortgage credit risk. However, at least 90% of the mortgage market is currently financed through government programs, including guarantee programs administered by the FHA, the Veterans Administration, and the GSEs. Investors will be much less willing to invest in mortgage assets as a result of the losses and lack of legal certainty caused by an eminent domain action, thus frustrating the federal government’s policy goal and leaving taxpayers exposed to excessive levels of mortgage credit risk.

## **Lack of Support by the Federal Housing Administration and Fannie Mae and Freddie Mac will make the Plan Unworkable**

MRP places great reliance on the FHA as a key component of its proposal. MRP's strategy, as contained in its marketing plans, is for the seized and repackaged loans to be financed and insured by FHA. FHA is essential as the financing vehicle since Fannie Mae and Freddie Mac (the "GSEs") and their regulator, the Federal Housing Finance Agency, have indicated their concerns about the eminent domain programs and resistance to refinancing the seized loans. However, on May 17, 2013, Deputy Assistant Secretary of the U.S. Department of Housing and Urban Development ("HUD") and FHA official Charles Coulter testified before Congress against such a role for the FHA. He stated: "It would be highly improbable, I believe, for FHA to put itself in a position where we would be the only insurer on those types of refinance transactions." Without GSE or FHA participation, borrowers will have extremely limited hope of finding long term financing for their seized loan. MRP or the municipality will have to plan on the long term funding and managing of a portfolio of seized loans, which is a step neither has indicated a willingness to do.

## **Better Alternatives are Available to Help Borrowers in Need**

Federal programs such as the Home Affordable Modification Program (HAMP), the Home Affordable Refinance Program (HARP) and the streamlined modification initiative have helped millions of borrowers across the country refinance their mortgages. In May of this year all three programs were extended through 2015 to continue to provide assistance to borrowers. These refinancing options are better for both the borrower and the overall economy as they do not carry the additional risks posed by eminent domain and would not pose the threat of credit tightening and home price declines within communities. In addition, servicers have the authority to take actions to provide relief to borrowers facing financial difficulty, and will do so in a manner that balances the interests of all affected parties.

## **Conclusion**

SFIG urges local governments to reject calls to implement Eminent Domain Proposals. The Eminent Domain Proposals are illegal, bad public policy and contrary to the public interest of local communities and the nation.