Invested in America

August 27, 2012

VIA OVERNIGHT MAIL

The Honorable Martin J. Gruenberg, Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Use of Eminent Domain to Restructure Performing Loans

Dear Chairman Gruenberg:

The Federal Deposit Insurance Corporation has long been an invaluable advocate for responsible governmental and private sector programs to support home preservation for borrowers at risk of foreclosure. Dating back to the FDIC's pioneering work to address the perceived difficulties in modifying securitized mortgages in 2007 and the FDIC's leadership in developing the IndyMac loan modification protocol in 2008, and in its continuing leadership role on these issues, the FDIC has consistently focused on foreclosure prevention initiatives that achieve the best value for borrowers and mortgage holders alike. We, at SIFMA, have always valued the FDIC's focus on the importance of preserving market-based solutions to the stress in the housing markets. In contrast to the FDIC, some have advocated solutions that would impair the foundations of mortgage finance by fundamentally changing the contractual relationship between borrower and lender. We have always shared with the FDIC the belief that this was the wrong course to take because it would significantly undercut the safety and soundness of insured banks and impair the contract rights that necessarily must underlie any reform or revitalization of the private mortgage finance market.

Unfortunately, some investment groups and academics have recently been advocating for the use of the sovereign power of eminent domain to seize individual underwater mortgages from established private-held securitized pools. As you are no doubt aware, the County of San Bernardino, California, is considering a plan under which it would exercise eminent domain to seize performing underwater mortgages, transfer the mortgages to new private investors who would restructure the mortgages by writing down the outstanding principal and then selling the mortgages through FHA or Ginnie Mae programs. Such restructured mortgages would be insured by FHA and guaranteed and securitized by Ginnie Mae with American taxpayers bearing the risk. The proposal is inherently based on paying the current mortgage owners far less than the true value of these performing mortgages and transferring this additional value to the new private investors. Similar proposals are being considered in other jurisdictions across the country. However, given the inherent flaws in this approach, many legal analysts, investors, banks, trade associations, and

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thoughtful public officials, including Chicago Mayor Rahm Emmanuel and Federal Housing Finance Agency Acting Director Edward DeMarco have expressed grave concern.

While the search for solutions to the continued national problems in housing finance is understandable and appropriate, SIFMA also has grave concerns over these proposals. If implemented, they would fundamentally call into question the reliability of the mortgage contract and—by undermining the legal structure supporting secured mortgage lending—have permanent, negative consequences for the national housing finance system. We are only now beginning to see a gradual improvement in housing prices and the fundamentals of mortgage lending. However, the use of eminent domain to seize mortgages and transfer their inherent value from one group of private investors to another would place these gains at risk. We further note that the successor group of private investors would also receive substantial additional value from newly granted FHA insurance and Ginnie Mae guarantees. These actions, greatly enhancing the investment value of the transferred mortgage loans, would immediately eliminate any prospect of a return of private capital to U.S. mortgage markets. Ultimately, adoption of this approach would result in significant and long-term increased costs and decreased availability of mortgage credit and a further depression of home values.

The proposed use of eminent domain to seize and restructure underwater mortgages is fundamentally different from previous U.S. foreclosure prevention initiatives. It abandons the principle of maximizing net present value ("NPV") that underpins all of the FDIC's and U.S. Treasury's loan modification programs. Instead of applying a market-based solution to foreclosures based on achieving a superior NPV through modification, restructuring, short sales or, if unavoidable, foreclosure, the use of eminent domain would abandon any attempt to comply with existing contracts and market expectations. Eminent domain would substitute an exercise of governmental power for the contractual rights in a mortgage without any showing that the action reduced the likelihood of default or improved the long-term prospects of the borrower.

As noted above, the proposals under discussion in San Bernardino County and other municipalities also fail even to provide fair value to the owner of the mortgage. These proposals contemplate seizing only currently performing underwater mortgages. The promoters of this approach have argued that new investors in their scheme can reap substantial profits because the 'fair value' to be paid for the mortgage will be "significantly less than the fair value of the home." Based on the public materials released by proponents, the fair value for these performing mortgages would be estimated using the market value of nonperforming loans sold on the secondary market. This is particularly startling since these performing underwater mortgages have continued to perform for years during the long-term decline in housing prices experienced in many areas of the country, including San Bernardino County. Given these features, and based on our analysis of the publically released details of the proposals and the remarks of their main proponents, the proposed "fair value" compensation is likely to be substantially less than the actual value of the performing mortgages. Additionally, financial and accounting authorities have advised us that the compensable loss to the original investor would also include write-downs on the remaining residual of the original pools, losses caused by interest-rate risk to the funding transactions, and likely significant loss on the cancellation of hedge instruments.

Adoption of this, or similar, eminent domain approaches would have an immediate impact on the short and long-term interests of those who have long financed our mortgage markets – bankers, individual investors, pension funds, insurance companies, and many others. We should not forget that a deep and liquid mortgage market in the United States has long been a sound foundation for much upward mobility and economic development. While our ongoing national recovery from the collapse of the speculative housing bubble has proven difficult, we should not abandon the underpinnings of that market.

These proposals also raise serious U.S. and state constitutional, as well as other legal, issues. The U.S. Constitution permits government seizure of private property if such takings are made for a public purpose in exchange for just compensation. This authority has long been used sparingly to achieve clear public purposes by taking real property to, for example, construct hospitals, roads, and other needed infrastructure projects. The use of eminent domain to condemn intangible property, such as a mortgage, has very rarely been attempted because the relationship to the requisite public purpose is difficult to establish and it is a significant departure from the historical antecedents and precedents for the use of this extraordinary public power. Indeed, under these proposals, the requisite link between the seizure of mortgages and the public purpose of mitigating and reversing economic degradation is even more attenuated. As noted above, in the San Bernardino County proposal the government would only seize performing underwater mortgages—those that are least likely to default and lead to blight and economic degradation. Even if the proposal were limited to mortgages in foreclosure, the nexus between the remedy and the public purpose remains insufficient because it is very doubtful that any public benefit can be achieved through the condemnation of scattered mortgages in a jurisdiction as large as San Bernardino County. The constitutionality of the use of government power to force transfers of private property from one private party to another also is constitutionally suspect. This feature calls into question the suggested public purpose and further underscores the ephemeral relationship between the proposed governmental action and the essential public purpose required to justify a taking. Furthermore, as noted above, the takings by design will not meet the requirement of just compensation. The proposed method for estimating fair value as well as the projected private profits to the new investors undercut any plausible argument that just compensation is being provided. In summary, all of these constitutional difficulties will lead to protracted litigation and create a cloud of uncertainty that would impose significant costs on both borrowers and lenders/investors.

While the jurisdictions considering these proposals may indeed hope to improve local economic conditions, the primary beneficiaries would be private third-party investors who would acquire performing mortgages at a generous discount, individual borrowers who would receive steep haircuts on interest payments and principal balances and local politicians who would curry favor with their constituents. In fact, given the questions that the use of eminent domain, and the resulting litigation, will raise for bankers, investors, and the public participants in the mortgage markets, such as the FHA, Freddie Mac, Fannie Mae, and Ginnie Mae, such proposals are more likely to increase future mortgage costs and decrease the availability of mortgage credit, and thereby further depress housing prices, in jurisdictions that adopt such an approach.

We believe that the FDIC's core interests, as well as those of our member institutions (many of whom are insured depository institutions), are at stake in this matter.

This use of eminent domain would cause immediate and significant declines in the value of private-label MBS supported by the cash flows from seized mortgages, and would create a pall of uncertainty over the value of other mortgages and MBS as investors attempt to quantify and price this new and unanticipated risk. This would directly harm the FDIC's interests both as a bank supervisor and as a bank receiver by compromising the safety and soundness of the depository institutions that hold mortgages and MBS, undercutting the value of the mortgages and MBS that the FDIC acquires in receivership, and ultimately threatening the Deposit Insurance Fund with further losses. The use of eminent domain in this manner would also undermine attempts to reform the government sponsored enterprises that currently support the U.S. housing market by discouraging the development of, and flow of private capital into, the private secondary mortgage market.

The Federal Housing Finance Agency has expressed great concern regarding the use of eminent domain to revise existing mortgage contracts because it could impact the value of MBS held by Freddie Mac, Fannie Mae and the Federal Home Loan Banks, and has requested input from market participants and other interested parties, asking for comments on the proposals by September 7, 2012. The FDIC, as a pioneer and leader in the area of foreclosure prevention, is in a unique position to provide meaningful insight to the FHFA. If the FDIC shares these concerns, we would urge the FDIC to provide the FHFA with its input regarding the significant impact the proposals would have on the interests of the FDIC and the U.S. housing market.

If SIFMA can be of any assistance in this matter, please do not hesitate to contact our organization.

Sincerely,

T. Timothy Ryan, Jr.
President and Chief Executive Officer