Invested in America

August 27, 2012

VIA OVERNIGHT MAIL

The Honorable Timothy Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Use of Eminent Domain to Restructure Performing Loans

Dear Mr. Secretary:

From the beginning of the financial crisis of 2008, the Department of the Treasury ("Treasury") has been a constant and invaluable advocate for responsible government and private sector programs to support home preservation for borrowers at risk of foreclosure. Treasury has consistently articulated policies and implemented programs aimed at promoting the economic recovery and financial stability of the United States through foreclosure prevention and the revival of the private mortgage finance industry. We, at SIFMA, have always valued Treasury's focus on the importance of preserving market-based solutions to the stress in the housing markets. In contrast to Treasury, 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 Treasury 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. Furthermore, we note that you have commented, in response to a question at the House Financial Services Committee, that such use of eminent domain may be sub-optimal and poses many complexities, and therefore requires careful review.

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-label 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. 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,

New York | Washington

120 Broadway, 35th Floor | New York, NY 10271-0080 | P: 212.313.1200 | F: 212.313.1301

www.sifma.org

banks, trade associations, and 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 than previous U.S. foreclosure prevention initiatives implemented by Treasury and other federal agencies. It abandons the principle of maximizing net present value ("NPV") that underpins Treasury's foreclosure prevention programs, including the Home Affordable Modification Program and the Home Affordable Refinance Program. 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 Treasury's goal of reforming the U.S. housing finance system and its core interests of promoting economic recovery and financial stability are at stake in this matter (as are the interests of the many SIFMA member institutions that play roles in the private mortgage market). 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. The immediate effect would be to impose losses on the institutions that invest in mortgages and MBS, including FDIC-insured depository institutions, taxpayer-supported institutions such as Fannie Mae and Freddie Mac, and the pension and other investment funds that manage much of America's retirement wealth. Over the long-term, the result would be to discourage the development of, and flow of private capital into, the private secondary mortgage market. If mortgage contracts can be seized on a large scale under eminent domain, it will materially, perhaps fatally, undercut the goal of restructuring mortgage finance to limit the U.S. government's currently predominant role.

We believe that the proposed application of eminent domain could constitute a threat to the financial stability of the United States and its continued economic recovery. The chaos and uncertainty likely to result in the housing market if these proposals go forward would not only harm the lenders and investors that provide credit to the private mortgage market, but also the borrowers who will face less and more expensive access to credit going forward. The last financial crisis demonstrated that negative pressures on housing can have profoundly negative implications for financial stability, especially when the mortgage market is already in a weakened state. As a result, we believe this may be a matter for appropriate consideration by the Financial Stability Oversight Council and we would urge your consideration of presenting it for discussion by the Council.

The Federal Housing Finance Agency has expressed grave 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 Treasury is uniquely positioned to provide meaningful insight to the FHFA, in particular regarding the implications of these proposals for financial stability and the overall U.S. economy. If the Treasury shares our concerns, we would urge the Treasury to provide the FHFA with its input regarding the significant impact the proposals would have on the U.S. housing market and overall economy.

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