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MBS Strategy Group

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Creative Uses of Eminent Domain—Implications For PLS Trusts

Summary

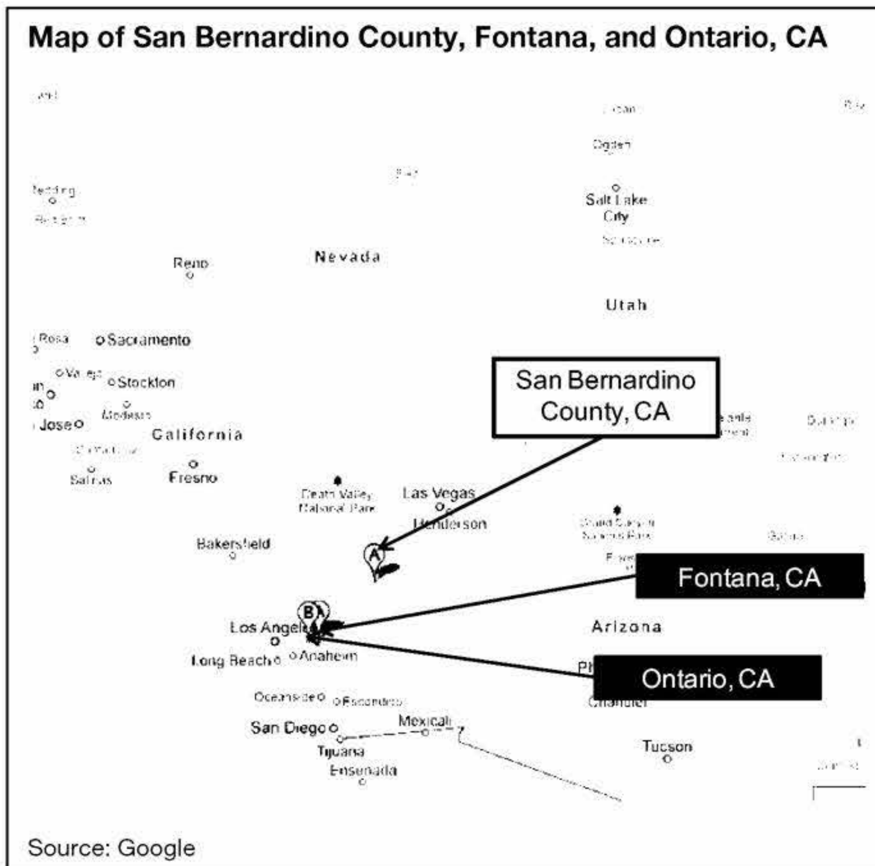
On June 19, 2012, San Bernardino County and 2 cities in that county (Ontario and Fontana) approved a resolution which paves the way for the municipalities to acquire underwater residential mortgages using the right of eminent domain. Under one proposed plan the targeted loans are performing underwater loans in PLS. While the program as approved would be quite small, we believe this use of eminent domain sets a potentially troublesome precedent. In this article, we discuss the pro-forma economics of the program, highlight (once again) why legacy PLS structures provide investors with little ability to protect themselves, discuss possible courses of investor action, and the consequences if no actions are taken.

On June 19, 2012, California's San Bernardino County Board of Supervisors approved an amended resolution, which established a Joint Exercise of Powers Agreement between the County of San Bernardino, the City of Ontario, and the City of Fontana. This agreement allows for the establishment of a joint powers authority that will "*take actions and make decisions to assist in preserving home ownership and occupancy for homeowners with negative equity within the Parties' jurisdictions, avoid the negative impacts of underwater loans and further foreclosures and enhance the economic vitality and health of their respective communities.*" It's dubbed the "Homeownership Protection Program," and is structured to allow additional cities to join.

This Homeownership Protection Program "*may include the Authority's acquisition of underwater residential mortgage loans by voluntary purchase or eminent domain.*" After these loans are purchased at fair market value, the intent is to restructure these loans to allow the homeowner to continue to occupy the property. The "*joint parties authority is permitted to modify, restructure, hypothecate, assign, pledge, securitize, convey or re-convey these loans and deeds or trust.*" The program clearly applies only to the loans; it expressly excludes the power to acquire the homes by eminent domain.

A Concern To PLS Investors

This ordinance allows the "taking" of mortgages at fair market value. One plan, sponsored by Mortgage Resolution Partners (MRP), being considered by the Joint Powers Authority is currently seeking capital to support this program. The loans targeted will be performing underwater loans in private label securitizations (PLS).



Source: Google

We understand the intent is to refinance these borrowers to just under the home's fair market value (97.75 LTV), using the FHA Short Refinance Program. The Homeownership Protection Program (HPP) structure would require that the local government entity take title to the loans, and pay the PLS Trusts with money provided by Mortgage Resolution Partners. When the loans are refinanced, the proceeds are used to repay investors who financed the HPP.

It is interesting that the targeted borrowers are expected to be those in private label securitizations, but not loans in GSE pools. [*NOTE:* FHA loans are ineligible for the short refinance program.] We believe this reflects the fact that private label securitizations (PLS) were poorly designed—the private label structure does not provide for a responsible party whose duty it would be to ensure that such a taking was legal and the "fair market" price was actually fair. If this program were to target GSE loans, the case would be certain to end up in court, challenged both on the legality of the program and the fair market determination.

We have long been concerned about the lack of flexibility, lack of transparency, and the passive nature of the servicer/trustee responsibilities in the PLS agreements. We are sympathetic to the basic premise that it is very difficult to get loans out of the private label trusts to allow them to be restructured and more actively managed. In particular, there is no mechanism for restructuring a performing loan within a PLS trust, and we have no doubt that many performing underwater loans will eventually proceed through foreclosure without some form of restructuring. Based on a very careful analysis of the total credit profile of the borrowers, it can be determined which of these loans are most likely to default, and taking select loans out of a trust could conceivably result in a higher realized value for PLS investors. Using eminent domain is a novel (albeit aggressive) idea to reach this goal. However, we suspect this program is being done without a careful analysis of which borrowers need the write down, and we also suspect that the parties are incented to purchase the loans below fair market price. Moreover, it is the lack of a "protector" for the PLS loans, potentially allowing for a purchase at less than fair value, which makes these loans an attractive target. The inability to write down performing underwater borrowers applies to GSE loans as well as PLS loans. (Principal reduction is an often used tool for non-performing loans in private label securitizations, an activity that we support; GSEs do not permit the use of principal write-downs under any circumstances.)

In this article, we focus on the Mortgage Resolution Partners version of the HPP program. We first detail the characteristics of the loans that we believe are targeted by this version of the program. We then describe our take on the pro-forma

economics of the HPP program, to the HPP investor, to the borrower, and to the PLS investor. In the third section we detail why private label investors have little protection. Finally, we cover why this use of eminent domain sets a very dangerous precedent that will add to the challenges of bringing back private label securitization.

BOTTOM LINE—While the HPP program is very small, the clear intent is to grow it. We believe this use of eminent domain sets a troubling precedent by targeting performing loans in private label securities; do not have a built-in mechanism that would protect them against a less than fair price. Programs like this highlight the need for securitization reform and, absent of such reform, show how it would be more difficult and expensive to bring private capital back into the market.

I. Targeted Borrowers

The borrowers targeted for this program are performing underwater loans in private label securitizations. We do understand that municipalities in which homes have lost close to 50% of their market value since housing's peak would want to "do something." We also understand that borrowers who are deeply underwater have a reasonable chance of defaulting going forward, adding to foreclosure inventory. A restructuring of the debt will lower the probability of default. However, if the targeted loans are performing and underwater loans—then the logic escapes us as how a municipality can make the case that the target should be only loans in private label securitizations, but not Fannie or Freddie loans, nor loans in bank portfolios.

While San Bernardino County is the first area to adopt this type of resolution, we do know that other municipalities have been approached by Mortgage Resolution Partners. And it is a very tempting proposition for communities that have suffered significant home price depreciation. Not only is it politically popular, but if the San Bernardino experience sets a precedent, the municipalities are getting paid for their participation in this program (as least under the MRP version of the HPP); these monies can be applied to reduce budget deficits or forestall property tax increases.

We decided to test how many loans could be affected if this resolution becomes widespread. Thus we grouped owner-occupied loans that were performing for 6 months, and had a mark-to-market LTV (loan-to-value) of ≥110. The results of our analysis, shown in Exhibit 1 (next page), indicate an aggregate of 4.2 million loans in private label securitizations. Of these, 1.4 million are at least 60 days past due (non-performing), 2.7 million are performing (current or 30 days past due), and 2.4 million of those 2.7 million have been current for the past 6 months. Approximately 0.5 million of the performing loans with a good pay history are non-owner occupied. Of the 1.9 million owner-occupied units, just over 0.5 million of them are sufficiently underwater to qualify for this type of program (173,000 have a 110–125 LTV and 359,000 have a >125 LTV). *That amounts to 12.7% of private label loans by count (or 15.4% by balances).*

Exhibit 2 (next page) shows the 532,000 loans for the potential program that are owner-occupied, current for the past 6 months, with a mark-to-market LTV ≥110,

Exhibit 1: PLS Loans Targeted for Eminent Domain—Loan Count and Balance

Performing Status	Pay History	Occupancy	MTM LTV	Loan Count	Balance ($Bil)
Non-Performing				1,426,016	358
Performing	Current < 6 Months			342,598	69
	Current ≥6 Months	Non-Owner Occupied		451,598	85
		Owner Occupied	≤100	1,268,897	305
			100-110	161,053	51
			110-125	172,534	56
			>125	359,325	102
		Owner Occ Subtotal		**1,961,809**	**514**
	Current ≥ 6 Months Subtotal			**2,413,407**	**599**
Performing Subtotal				**2,756,005**	**668**
Grand Total				**4,182,021**	**1,026**

Source: CoreLogic, 1010Data, Amherst Securities as of May 2012

Exhibit 2: PLS Loans Targeted for Eminent Domain—Characteristics

Region	Balance ($)	Count	Average Loan Size	WALA	FICO	% IO	Owner Occ (%)	Full Doc (%)	Multilien (%)	HPA CS (%)	LTV Orig	LTV MTM	CLTV Orig	CLTV MTM
US (ex. CA)	69,457,492,529	314,339	220,964	73	682	40	100	50	42	-43	81	146	86	159
CA (ex. Fontana and Ontario)	87,339,073,120	214,355	407,451	72	709	54	100	33	52	-44	78	141	83	155
Fontana and Ontario, CA	1,072,462,902	3,165	338,851	71	683	43	100	34	43	-50	78	154	82	167

Region	APL (%)	RPL (%)	Orig GWAC (%)	Curr APL/RPL GWAC Overall (%)	Curr GWAC APL (%)	Curr GWAC RPL (%)	Model Recovery Rate (% of Fair Value)	Model Recovery Rate (% of Curr Loan Balance)	% Default	Model Loss Severity (% of Curr Loan Balance)	Model Net Recovery (% of Curr Loan Balance, 100-Loss Severity)	Present Value of Loan (% of Curr Loan Balance)	Present Value of Loan (% of Fair Value)
US (ex. CA)	62	38	6.4	4.9	5.5	3.8	79%	54%	36%	64	36	65	95
CA (ex. Fontana and Ontario)	62	38	5.4	4.3	4.9	3.2	88%	62%	32%	50	50	71	100
Fontana and Ontario, CA	39	61	5.6	3.7	4.9	3.0	86%	56%	40%	57	43	66	101

Source: CoreLogic, 1010Data, Amherst Securities as of May 2012

broken down by loan characteristics. Our 3 groups are the 2 cities in San Bernardino County (Ontario and Fontana) that already approved the agreement, the balance of California, and the rest of the United States. Note that underwater, performing, owner-occupied loans are disproportionately located in California. While California has 21.2% of the private label universe by loan count and 34.8% by balance, it constitutes 41% of the loans that could be targeted by an HPP program by count and 56% by balance. Note also that the 2 cities in San Bernardino County that approved the resolution have only 3,165 loans meeting the necessary criteria. These 3,165 loans are distributed

across 1,533 deals, with 12 loans being the maximum in a single trust. *What concerns us is the precedent, not so much the impact of this one particular effort.*

The characteristics of the targeted loans are no surprise—680–710 FICO, 33–50% full documentation, 42–50% with second liens (multi lien %), and 40–54% were Interest Only (IO) loans at origination. The original LTVs were 78–81; current LTV is 154 for the 2 cities in San Bernardino County, with 141 and 146 for the balance of California and the rest of the nation, respectively. CLTV (combined loan to value) on the targeted loans are higher—167 for the 2 cities in San Bernardino County, with 155 and 159 for the balance of California and the rest of the nation, respectively.

Not surprisingly, this deeply underwater cohort contains many loans that have already been modified. Note that for the 2 affected cities, 39% of the loans are "always performing" (APL; never 2 payments or more behind), while 61% are "re-performing" (RPL; they have been two payments or more behind); most have become current via a modification (usually via an interest rate reduction). The gross WAC (weighted average coupon) on the APLs is 4.9%; the gross WAC on the RPLs is 3.0%, resulting in a blended gross WAC of 3.74%. For the balance of California and the rest of the nation, 62% of the loans are "always performing"; 38% are re-performing, with a gross WAC on the RPL loans of 3.8 and 3.2, respectively.

II. Economics of the Transaction—HPP Investors / Homeowners / PLS Investors

We believe that the intent (confirmed by investors who have heard the Mortgage Resolution Partners HPP pitch) is to buy the targeted loans out of the trusts at 75-80% of AVM (automated valuation model) on the property. It is unclear what type of AVM will be used—one including only distressed sales, only non-distressed sales, or a combination. AVMs are usually based on a mix of distressed and non-distressed homes. In an area that has many distressed sales, the AVM will reflect the mix (even though homes targeted for this program are neither distressed nor for sale).

The targeted homes will receive an FHA short refinance. This program (outlined in the HUD Mortgagee Letter 2010-23[1] and amended by HUD Mortgagee Letter 2012-5[2]) requires that:

- The homeowner must be in a negative equity position.
- The homeowner must be current on the existing mortgage to be refinanced. (If the Mortgagor successfully makes 3 consecutive on-time payments during the trial plan, the Mortgagor is eligible for a permanent loan through the FHA Short Refinance Program.)
- The homeowner must occupy the 1-4 unit property as their primary residence
- The homeowner must qualify for a new loan under standard FHA underwriting requirements and possess a FICO score ≥500. Standard FHA underwriting requires ≤31% housing DTI (DTI = [1st mortgage payment + 2nd mortgage payment + taxes + mortgage insurance premium + hazard insurance + homeowner's association dues + ground rent + any special assessments]) and a ≤43% back-end (total debt) DTI. Under the energy-efficient home policy, those limits can be stretched to 33% and 45%,

[1] The link is as follows: http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-23ml.pdf

[2] The link is as follows: http://portal.hud.gov/hudportal/documents/huddoc?id=12-05ml.pdf

respectively. In some circumstances compensating factors can permit the limits to be exceeded. Note that FHA Short Refinance Program will need a new appraisal; an automated valuation model (AVM) or broker price opinion (BPO) is insufficient to establish value.

- For loans that receive a "refer" risk classification from TOTAL Mortgage Scorecard, the housing DTI should be ≤31% and the back-end DTI ≤50%; the housing DTI can be ≤35% if the back-end DTI is ≤48%.
- The existing loan to be refinanced must not be an FHA-insured loan.
- The existing first lien holder must write off ≥10% of the unpaid principal balance.
- The refinanced FHA-insured first lien must have an LTV of ≤97.75%.
- Non-extinguished existing subordinate mortgages must be re-subordinated, and combined LTV on the new loan must be ≤115%.
- All loans made under this program must close on or before December 31, 2014.

Let's assume the first lien is written down to 97.75 LTV. *What happens to the second liens in these transactions*? It is unclear to us how this would be handled. The most logical alternative is that since the first lien is being taken by eminent domain, they also take the second lien. However, the banks would most certainly protest whatever "fair market value" is selected. It is conceivable to us that the second lien would not be taken by eminent domain, and thus would be left intact in some instances or re-negotiated in others (And there may be situations in which the presence of a large second makes it economically unattractive to take the first lien). The FHA Short Refi Program allows the second lien to be re-subordinated in its entirety if it is <17.75% of the current market value (115–97.75%). Thus, many second liens would require no write down. If the amount of the second lien is greater than that, then Mortgage Resolution Partners, as program sponsor, can ask the second lien holder to take a write down, in exchange for a second that is more likely to pay plus some cash.

This is possible because of the flexibility afforded second liens in the FHA Short Refinance Program. FHA short refinance rules allow that: *(1)* the first mortgage can be taken out for <97.75% and the second can comprise the difference (up to 115 LTV); or *(2)* a first lien of up to 97.75% LTV can be taken out, with cash from this used to pay down some of the second lien debt, as long as all of the criteria above are met. Thus, if the first lien were 110 LTV and the second lien was 25 LTV—the program would permit a 90 LTV first mortgage and a 25 LTV second mortgage (keeping the second intact). Alternatively, the FHA short refinance program would permit a new FHA mortgage to be taken out for 97.75 LTV, with the first lien written down to 90, and the 7.75 difference used to pay down the second lien. So the second lien holder remains intact, with a 17.25 mortgage and cash of 7.75%.

For first lien investors, the economics of this transaction depend critically on the level at which the loans are being purchased out of the Trust. For the purposes of the analysis below, we will assume the intent (confirmed by several investors who heard the the HPP pitch) is to purchase the loans at 80% of the market value of the property based on the AVMs. If the loans are purchased at 100% of the market value of the property, the economics become much less appealing to the HPP investor, and closer to fair value for the PLS investor.

Now let's look at the economics of the transaction to the HPP investors. Assume: (1) the loans are purchased out of the trust at 80% of the market value of the property based on AVMs, and refinanced into a 97.75% LTV FHA mortgage, and (2) the rate offered on the new mortgages were 4.0%. These mortgages could be sold into a

GNMA 3.5 pool at 106 (August settlement). Thus, the sponsor essentially obtains the mortgages at 80% of the property value and sells the FHA loans at 103.61% of the property value (97.75 x 1.06). We understand that the Joint Powers Authority must get paid something for their efforts. Discussions with market participants who were pitched on the program indicate that the Joint Powers Authority is slated to receive about 5 points per 100. In addition, not all the loans will qualify for the FHA short refinance program. This program requires the loans to be current. To the extent the borrower goes delinquent during the process, he is not eligible for the short refinance program (hence we assume that the loans that will be targeted will have 6 months of clean history). To the extent the borrower is unwilling to submit the documentation, or does not qualify for the short refi program (because of either DTI ratios or FICO scores), the loans will fall out and will be sold in loan form. However, if the AVM is low (and we argue it is likely to be below the fair market value of the property or the loans), then even the loans that "fall out" are unlikely to be sold at a loss. Mortgage Resolution Partners are receiving a per loan fee for structuring the transaction. There are also some costs of FHA origination that must be paid for out of the differential between the acquisition price of 80% of fair property value and the disposition of 103.61% of fair property value. ***In summary, if the imposition of eminent domain occurs at a price of 80% of property value, investors in the HPP program will realize significant returns.***

Now we'll consider the borrower. Assume a current loan for $300,000 on a home worth $200,000, so the mark-to-market LTV is 150. The borrower is currently paying a gross WAC of 3.75% (the average rate on these loans), and assuming the loan must amortize over a remaining maturity of 288 months (weighted average loan age of 72 months) suggests a current monthly payment of $1,584.72/month. Assume the borrower is refinanced into a new 30-year first mortgage for $195,500 ($200,000 x 0.9775) at a 4.0% interest rate. The mortgage insurance premium is an upfront cost of 1.75% (which can be rolled into the loan amount) + 1.25% per annum. Thus, the new loan amount (rolling in the upfront premium) is $198,921; the new monthly interest rate is 5.25% (the 4.0% gross WAC + the 1.25% annual mortgage insurance premium), for a payment of $1,098.45. Thus—*the borrower is certainly better off. He has a lower monthly payment, and has been re-equified.*

Finally, consider a private label investor whose loans were sold out of the trust at 80% of market value. It is difficult to price these assets from comparables, as there is no real market for 150 LTV, 170 CLTV first liens that have not been delinquent in the past 6 months. We can estimate the fair value of the performing loans by assuming the investor is paid back in full on the loans that do not default; loans that default are liquidated at the severity appropriate to their loan characteristics. In the case of the loans above, assume the probability of default at 40% (this number is taken from the bottom section Exhibit 2). Thus, he has a 60% chance of eventually collecting $300,000 (but we must calculate a discount for the low coupon of 3.75%). Using a 6% discount rate (and the numbers are very sensitive to this discount rate), for value of the non-defaulted $300,000 claim is $243,582). The value of the defaulted claim is 43% of the original loan amount or $129,000. [*NOTE*: Recoveries are estimated to be 86% of the fair value of the property, or 56% of current loan balance, as shown in the bottom right section of Exhibit 2 for Ontario and Fontana. We must subtract the costs of foreclosure plus the value of taxes, insurance and excess depreciation during the foreclosure process, while the borrower is in the home but not paying. Thus, we calculate a severity of 57%, and a recovery of 43% of the current loan amount.] In our

example, the investor has a 60% chance of collecting $243,582 and a 40% chance of collecting $129,000, for an expected value of 197,749, or 98.9% of the fair market value of $200,000 (which is 66% of the current loan amount). Note that across the universe of loans, the "fair value" of the loans is very close to 100% of the value of the property.

Thus, if the private label loans are taken out of the trust at 80% of the value of the property, the private label investor would fare very poorly. Performing loans would be taken out of the trust without representation, with insufficient compensation (80% of current property value versus our estimated value of 100%). The PLS investor is also losing the option that the situation will improve; default rates will continue to decline, and home prices will at some point rise. If the PLS investor were compensated at the fair value, it would significantly reduce any profit for the HPP investors. And, as we show in the next section, compensation at fair value is unlikely, as the PLS investor is relatively defenseless.

III. Who's Looking Out For The Trust? (Neither Servicer nor Trustee Have That Obligation)

We argue that servicers and trustees (and trust administrators, if applicable) of non-agency trusts have no obligation to challenge a fair value estimate arising from the execution of eminent domain. We spent significant time with the governing documents, and we see no specific provisions where the servicer or trustee would be required to act on behalf of the PLS investor to ensure the application of eminent domain was at a "fair" price. We are not lawyers, but the documents appear to provide plenty of opportunity for servicers and trustees to take a passive role in this circumstance. To illustrate this point, we will use the Pooling and Servicing Agreement[3] (PSA) for OOMLT 2007-1, a subprime Option One transaction (selected because we see the PSA as a relatively generic RMBS agreement and broadly indicative).

a) Servicer's Responsibility to (*Not*) Act

If a loan were purchased out of a trust at fair market value through the eminent domain strategy, this fair market value would most likely be at some discount to the par value of the mortgage, which would create a loss on the loan. So, while liquidations are generally considered to originate from defaulted loans, it can be easily argued that an eminent domain purchase is a liquidation event as per the PSA. The PSA defines Liquidation Event and Proceeds as follows:

> ***"Liquidation Event"***: *With respect to any Mortgage Loan, any of the following events: (i) such Mortgage Loan is paid in full, (ii) a* ***Final Recovery Determination is made as to such Mortgage Loan*** *or (iii) such Mortgage Loan is removed from the Trust Fund by reason of its being purchased, sold or replaced pursuant to or as contemplated by Section 2.03 or Section 10.01. With respect to any REO Property, either of the following events:* ***(i) a Final Recovery Determination is made as to such REO Property*** *or (ii) such REO Property is removed from the Trust Fund by reason of its being sold or purchased pursuant to Section 3.23 or Section 10.01.*

[3] The link as follows: http://www.sec.gov/Archives/edgar/data/1385902/000088237707000327/d616712_ex4-1.htm

> ***"Liquidation Proceeds"***: *The amount (other than amounts received in respect of the rental of any REO Property prior to REO Disposition) received by the Servicer in connection with (i)* ***the taking of all or a part of a Mortgaged Property by exercise of the power of eminent domain or condemnation****, (ii) the liquidation of a defaulted Mortgage Loan by means of a trustee's sale, foreclosure sale or otherwise or (iii) the repurchase, substitution or sale of a Mortgage Loan or an REO Property pursuant to or as contemplated by Section 2.03, Section 3.23 or Section 10.01.*

As you can see above, eminent domain is referenced specifically in the definition of Liquidation Proceeds. In fact, the term is only referenced in one other place in the PSA (where the originator reps and warrants there were no outstanding eminent domain claims on properties). (Although clause (i) of the definition of Liquidation Proceeds refers to a Mortgaged Property instead of the mortgage loan itself, given the lack of other provisions relating to the taking of a mortgage loan itself, this clause could likely be interpreted to be relevant.)

What is the servicer obligated to do in the case of a taking of all or part of the property by eminent domain? As outlined in the section on Final Recovery Determination, the servicer is obligated to make sure they received the recoverable proceeds on a property. Here is the definition of Final Recovery Determination:

> ***"Final Recovery Determination"***: *With respect to any defaulted Mortgage Loan or any REO Property (other than a Mortgage Loan or REO Property purchased by the Originator or the Servicer pursuant to or as contemplated by Section 2.03 or 10.01), a determination made by the Servicer that all Insurance Proceeds, Liquidation Proceeds and* ***other payments or recoveries which the Servicer, in its reasonable good faith judgment, expects to be finally recoverable in respect thereof have been so recovered****. The Servicer shall maintain records, prepared by a Servicing Officer, of each Final Recovery Determination made thereby.*

So the servicer is really just required to make sure they deposited in the trust the full amount of proceeds from the eminent domain taking.

b) Trustee's Responsibility to (*Not*) Act

Article VIII of the PSA contains trustee relevant provisions. Section 8.01 of the PSA discusses the "Duties of the Trustee." The first two sentences of this section highlight the basic responsibilities of the Trustee (i) prior to an event of default (defined in that PSA as a Servicer Event of Termination) and after such event of default is cured and (ii) when an event of default is occurring and continuing (which we will refer to as "in effect" herein):

While an event of default is not in effect, the Trustee "undertakes to perform such duties and only such duties as are specifically set forth in [the PSA]".

If there is an uncured event of default that a responsible officer of the Trustee has knowledge of (*i.e.*, the event of default is in effect), then the Trustee must "exercise such of the rights and powers vested in it by [the PSA], and use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."

Much of Section 8.01 limits the Trustee's duties and obligations further. For instance:

> *The Trustee, **upon receipt of all resolutions, certificates, statements, opinions, reports, documents, orders** or other instruments furnished to the Trustee which are specifically required to be furnished pursuant to any provision of this Agreement, **shall examine them to determine whether they conform to the requirements of this Agreement**; provided, however, that the Trustee **will not be responsible for the accuracy or content** of any such resolutions, certificates, statements, opinions, reports, documents or other instruments. If any such instrument is found not to conform to the requirements of this Agreement in a material manner the **Trustee shall take such action as it deems appropriate to have the instrument corrected, and if the instrument is not corrected to the Trustee's satisfaction, the Trustee will provide notice thereof to the Certificate holders** and the NIMS Insurer.*

So if the Trustee is required to look at the documentation provided by the Servicer (if any) it must only make sure that it looks acceptable on its face. Moreover, since there are not likely to be any specific obligations of the Trustee relating to eminent domain takings of mortgage loans, the Trustee is not likely to take any further actions.

Sections 8.01, 8.02 and 8.03 further discuss how the Trustee has no real obligation to pursue/fight an eminent domain sale. Absent the Trustee's negligence, Section 8.01(v) provides that:

> *prior to the occurrence of a Servicer Event of Termination and after the curing of all Servicer Events of Termination which may have occurred, the Trustee **shall not be bound to make any investigation into the facts or matters stated in any resolution, certificate, statement, instrument, opinion, report, notice, request, consent, order, approval, bond or other paper or documents, unless requested in writing to do so by the NIMS Insurer or the Majority Certificate holder**;*

Section 8.02(a)(vi) further provides that—other than as provided in Section 8.01 (*e.g.*, negligence or perhaps the post event of default prudent person standard) – the Trustee:

> *shall not be accountable, shall have no liability and makes no representation as to any acts or omissions hereunder of the Servicer until such time as the Trustee may be required to act as Servicer pursuant to Section 7.02 and thereupon only for the acts or omissions of the Trustee as successor Servicer;*

Moreover, Section 8.03 provides:

> *... The Trustee makes no representations as to the validity or sufficiency of this Agreement or of the Certificates (other than the signature and authentication of the Trustee on the Certificates) or of any Mortgage Loan or related document. **The Trustee shall not be accountable for the use or application by the Servicer, or for the use or application of any funds paid to the Servicer in respect of the Mortgage Loans or deposited in or withdrawn from the Collection Account by the Servicer...** The Trustee shall at no time have any responsibility or liability*

for or with respect to the legality, validity and enforceability of any Mortgage or any Mortgage Loan, or the perfection and priority of any Mortgage or the maintenance of any such perfection and priority, or for or with respect to the sufficiency of the Trust or its ability to generate the payments to be distributed to Certificate holders under this Agreement…

BOTTOM LINE—*We believe the Trustee will take the position that it has little or no obligation to ensure fair value is received in the event of an eminent domain sale.* Since it appears that neither Servicer nor Trustee have the fiduciary obligation to fight for fair value in eminent domain "takings," investors have very little representation. And the fact that each trust will have relatively few loans affected from each additional municipality that signs on to this program, makes it even more unlikely the eminent domain calculation of fair value will be contested. Moreover, it is not clear that the trustee (or other reporting party, as applicable) even has the responsibility to report which loan liquidations were the result of eminent domain activity, although we hope that they interpret their reporting obligations to require such disclosure as aggregating any eminent domain proceeds with liquidation proceeds would fail to give a complete picture to investors.

Eminent Domain—A Potentially Troublesome Precedent

We are very concerned that this use of eminent domain sets a potentially troublesome precedent. It gives the government a call on the loans, allowing for a re-strike of the loans, for what could be political motives. And it is likely to impact the willingness of investors going forward to purchase loans from this municipal area. This cost is irreversible.

As mentioned earlier, we are sympathetic to the fact that there is no way to restructure loans in a PLS, unless they are in imminent danger of default. And, even then, there is insufficient transparency to the investor on the restructurings (modifications). Thus, eminent domain could conceivably be used to do what the PSAs do not allow for—restructuring of performing loans under tightly guarded parameters. While we are sympathetic to this, we believe the troublesome precedent and impact on future borrowing outweighs this cost.

Even if we believed that there were a strong case to use eminent domain for this purpose, we would argue there is a better way to structure this program which more effectively preserves the rights of investors, but achieves the same result for performing underwater borrowers—the opportunity to refinance in an FHA short refinance loan. One possibility—the County of San Bernardino could work with a community-based housing organization to aid the borrower in filing out the FHA application, and work with the second lien holder to re-subordinate and possibly take a writedown. A warehouse line could be established by the Joint Authority in which, just prior to approval by FHA, it is taken by eminent domain, and funded until it can be placed in an FHA pool (FHA would have to give the county a heads up). The private label investors (or GSEs or bank lenders) receive about 103% of market value, not 80%. The Joint Authority does not receive its cut; the investors providing capital to this scheme do not benefit disproportionately, but the economics to the homeowner are the same.

What Has Experience Taught Us?

It is not unusual to find public policy goals in conflict. On one hand you want to further a public policy goal (in this case, preventing additional foreclosures), on the other hand there is a cost to mortgage holders. We can think of two precedents—the experience with PACE loans (loans to promote energy efficiency) in 2010 and the Georgia High Cost Lending Law in 2002. In both situations, the GSEs stood up to assert their rights. The difference in this situation is that the investors are less likely to do so.

In fact, this situation is very reminiscent of the PACE (Property Assessed Clean Energy) experience[4]. In areas with PACE legislation, the municipal government loans money to consumers and businesses for an energy retrofit; this is funded through a bond issue. These loans are repaid over 15–20 years, through a special assessment added to property tax bills. As initially conceived, the debt would be senior to existing mortgage debt, so if a homeowner defaults or goes into foreclosure, the PACE obligation would be repaid before the mortgage lender gets his money. While property tax assessments are usually senior to existing property debt, allowing property taxes to be used by homeowners that elect to make upgrades to their own homes create a dangerous precedent. Fannie Mae announced in August 2010 that they would not purchase mortgage loans secured by properties with an outstanding PACE obligation unless the terms of the PACE program do not permit priority over first mortgage liens. And for borrowers with loans securitized by Fannie Mae, who obtained a PACE loan prior to the July 2010 cut-off and want to refinance, the lender must first attempt to arrange a cash-out or limited cash-out refinance option, with the PACE loan paid off as part of the refinance. If the borrower is unable to qualify for this, the PACE loan payment must be included in the monthly housing expense calculation.

Fannie's press release addressed the dangerous precedent head on. Their language is as follows:

> *Fannie Mae supports the need for programs to help homeowners fund energy efficiency improvements, and believes it may be accomplished without altering the lien status of first mortgages. In the event that PACE or similar programs with automatic lien priority proliferate, Fannie Mae will consider further limitations as necessary to address safety and soundness concerns passed by PACE programs, in line with the July 6, FHFA statement. These restrictions may include tightening borrower debt-to-income ratios or loan-to-value ratios in jurisdictions offering such programs.*

We wish the author of that press release was available to help write this article!! But real world—where are we now with PACE loans? A minority of the 16 states that allowed localities to establish PACE programs have required that the PACE loans be subordinate to the first mortgage. However, the bulk of the PACE activity was effectively stopped by FHFA and OCC guidance. (On June 15, 2012, FHFA took more formal action, by issuing a Notice of Proposed Rulemaking (NPR), as required by a preliminary injunction issued by the Northern District Court of California.)

Georgia enacted a very tough Fair Lending Act in April 2002, effective October 2002. A loan of $20,000 or more is classified as High Cost if the total [point + fees] exceeds 5% of the loan amount (higher limits apply to smaller loans). This law provided a very

[4] For further information on the PACE experience, see FHFA Statement on Certain Retrofit Loan Programs, July 6, 2010, and Fannie Mae announcement SEL-2010-12 "Options for Borrowers with a PACE Loan."

stringent set of limitations for these loans, with strict penalties for non-compliance. While the rule was intended to protect borrowers, it left lenders very exposed, and making "high-cost loans" in Georgia was a poor business decision. The result—both Fannie and Freddie left the "high-cost loan" market in Georgia (Freddie Mac in November 2002; Fannie Mae in January 2003).

The likely result of this eminent domain activity for borrowers is that it will make future mortgage borrowing more costly, as investors will demand ever higher premiums to buy a new private label securitization. And as for the GSEs and bank portfolios—they are not included in this round, but could be included in the next. Thus, they too might build in a risk premium in these areas.

What Actions Can be Taken at this Point?

There has been widespread market concern that the price paid under the HPP will be low (although we don't know the price), and investors have little real protection. Thus, there has been a good deal of discussion among investors as to what actions can be taken. Much of the discussion has centered on trying, through non-legal channels, to stop municipalities from using eminent domain in this context. Let's enumerate the specific actions that investors have contemplated, with our spin on the implementation difficulty and likely success of each:

- Investors can bring a lawsuit questioning the legality of this use of eminent domain, but several large market participants would end up funding the lawsuit, as there is no mechanism for cost sharing.
- Investors can seek to apply business pressure to stop the HPP program—they will not work with any of the servicers, originators, investment banks involved in the program. If this were followed up on, it would be successful in many cases; however, some of these entities are not reliant on business from PLS investors.
- Investors and dealers, through SIFMA (Securities Industry and Financial Markets Association, the trade organizations for the securities industry), can conceivably determine that loans from affected areas would not be good delivery for TBA agency pools going forward[5]. This would require Fannie and Freddie to build screens in their systems to filter out certain zip codes. The loss of TBA eligibility would raise the cost of all future borrowings from affected areas. A less effective possibility would be to make FHA short refi loans ineligible for GNMA TBA delivery. However, this possibility cannot change the economics enough to thwart the program.
- The final possibility is that the GSEs step in on the side of PLS investors. It is important to realize that Fannie and Freddie together hold $112.9 billion of PLS, more than 10% of all PLS outstanding, and these portfolio holdings are clearly affected. If FHFA and the GSEs announced that the GSEs will be unwilling to insure loans in municipalities which are using eminent domain in this manner, it would stop the program immediately.

[5] It would be infeasible to exclude loans that have already been pooled.

Investors Need Representation with Fiduciary Responsibilities

We just showed that the private label securitization structure is inherently flawed; no one has a fiduciary responsibility to look out for investors. The results of this oversight are apparent on all fronts. Who is charged with looking at the fair value determinations that arise from the use of eminent domain and making sure they are fair to the investor? Who enforces the representations and warrantees in the PSAs on behalf of the investors? Who looks at the expenses relating to liquidations from an investors' perspective (long timelines, liquidation proceeds that bear no relationship to the value of the loan and the property, and, what many regard as excessive fees)?

In future securitizations, there is an acute need for an investor representative—with a fiduciary responsibility to represent investor interests. Investors need representation and a voice; a fiduciary achieves that goal.

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