September 7, 2012

Alfred Pollard, Esq.
General Counsel
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, DC 20024

Re: ***Use of Eminent Domain to Restructure Performing Loans***

Dear Mr. Pollard,

The undersigned organizations ("We") submit this joint response to the Federal Housing Finance Agency's ("FHFA") August 9, 2012 publication of a notice requesting comments on the potential use of eminent domain to take mortgages from private-label mortgage-backed securities ("PLMBS") held in existing investment portfolios and restructure such loans through the Federal Housing Administration ("FHA") and Ginnie Mae. [1] We share the concerns expressed by the FHFA in its request for comments.

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[1] 77 Federal Register 154 (August 9, 2012) p47652.

Our organizations are united in opposition to the current proposals to use eminent domain in this manner, and are actively working together to advocate against this clear abuse of the sovereign power of eminent domain. [2,3] We emphasize that recently proposed plans regarding the use of eminent domain to seize mortgage loans are highly likely to be found unconstitutional on multiple grounds and otherwise in violation of federal and state laws.

The FHFA's notice raises a number of specific concerns with the proposal: the risk of loss to Fannie Mae and Freddie Mac, and to the Federal Home Loan Banks ("FHLB"), and the resulting costs that would be imposed on U.S. taxpayers as a result of such losses; the chilling effects on credit extension and on investment in housing markets; the constitutionality of the proposal; the application of federal and state consumer protection laws; the impact on current security holders; the impact on millions of negotiated mortgage contracts; the role of courts in oversight of such plans and availability of resources; the fees and costs associated with the proposal; and valuation issues for these complex contractual arrangements traded in national and international markets.

We share each of these concerns. The proposed use of eminent domain directly affects our shared national interest in reform of our mortgage finance markets to reduce the role of the government in funding mortgage lending. In this letter we focus on three critical aspects of this issue: (1) the impact of eminent domain plans on mortgage lending, mortgage finance markets and mortgage investors; (2) concerns regarding valuation and the profit motivation that underlies this scheme; and (3) legal considerations.

1. Potential Impact of Eminent Domain Plans on Mortgage Markets and Mortgage Investors

We share FHFA's serious concern regarding the potential for a severe, negative impact on mortgage markets, and therefore on mortgage borrowers, if these proposals go forward. The use of eminent domain in this manner will confront lenders and investors with an unquantifiable new risk—the unpredictable use of eminent domain condemnation to seize their loans at a significant loss. As a result, these proposals would reduce the sources of funding for mortgage originators, and cause originators to underwrite in a defensive manner, therefore reducing credit availability. Moreover, the "taking" would also impact mortgage servicers. The "taking" of performing mortgages would eradicate the primary income stream of the asset and leave the servicer with only the high expenses of the non-performing loans likely leading to an implied servicing premium in areas exercising such use of eminent domain. Lenders and investors will pull back from funding mortgage lending in jurisdictions that implement such plans.

These negative effects on the mortgage markets and the availability of credit will vastly outweigh any small benefits that jurisdictions might hope to achieve using these proposals. Because the proposals

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[2] For the purposes of this letter, we will discuss eminent domain proposals with frequent, but not exclusive reference, to the proposal promoted by the investment firm Mortgage Resolution Partners (MRP) in San Bernardino County, California, and elsewhere. MRP's proposal to use eminent domain to seize uninsured mortgage loans held in PLMBS is premised on using the FHA and Ginnie Mae to refinance and resecuritize the seized loans with the great added value benefit of government insurance and guarantees, respectively. This use of FHA and Ginnie Mae would lock in a tremendous profit for the backers of the scheme, as the loans would be seized from PLMBS trusts at a level below their actual value to holders and sold at a premium in FHA insured and Ginnie Mae guaranteed MBS.

[3] We further note that PLMBS, the initial "takings" target of the MRP plan, almost always constitute below 20% of the residential mortgage loans in municipalities nationwide; accordingly, any such plan is likely to migrate to other investor portfolios, including Fannie Mae, Freddie Mac, banks and other whole loan investors.

would target only those borrowers who are current on their mortgage payments, not those who have fallen behind on payments or nearing foreclosure, they would not help the persons in greatest need, but rather selectively assist only those persons whose mortgages provide the best returns to the promoters. Foreseeable foreclosures and presumed ensuing neighborhood blight would not be materially reduced. A sliver of borrowers might be helped, but all those seeking credit would be harmed as this action would most certainly result in mortgage investors seeking a significant risk premium to compensate for the risk of seizure by eminent domain condemnation. Our members estimate that fewer than 3,500 borrowers would be eligible for the plan in San Bernardino County and proportionally very small numbers of borrowers elsewhere. Since all borrowers would suffer from increased costs for credit and reduced credit availability, any claim that the proposed use of eminent domain serves a public purpose is unsupportable. Alternatively, if the proposals were extended to delinquent borrowers, the resulting misalignment of borrower incentives would magnify moral hazard risk, threatening a flood of strategic defaults, while the likelihood of any public benefit would remain low, as only a small, scattered fraction of the mortgages in any particular jurisdiction would be restructured. Also, it is widely known that there are a number of national and local mortgage loan modification programs that are underutilized; with the requisite awareness and planning, we believe borrowers could greatly benefit from increased utilization of them.

For each instance of a "taking," the resulting losses to holders of the seized mortgages would be borne by citizens saving and investing for retirement, education, and other worthy goals. Investment managers with investments in mortgage-backed securities manage the investments of tens of millions of citizens through their management of pension funds, mutual funds, 401(k) plans, and other retirement and savings vehicles. While each "taking" proposal would be targeted to a small group of borrowers in a specific jurisdiction, the effects would be felt around the nation, as millions of Americans would see their retirement and other savings diminished.

The net consequence of these effects would impair significantly the contractual underpinnings for private investment in mortgage markets. Investors would flee these markets, and there would be no liquid markets for mortgage finance outside of the government-guaranteed markets. This would be a bad outcome for consumers and the nation as a whole. In his July 31, 2012 *Letter to Congress*, Acting Director of the FHFA, Edward DeMarco, discussed the potential unintended, but long-term, detrimental consequences to Fannie Mae and Freddie Mac and the mortgage markets that could result from casting doubt on the security of mortgage contracts.[4] In this extreme case, credit markets would instantly tighten as investors would be forced to reexamine the validity of mortgage contracts and account for a new type of risk. The irreparable damage to the recovering national housing market cannot be overstated.

2. Concerns Regarding Valuation and the Profit Motivation that Underlies this Scheme

An examination of how the proposals would allocate losses and profits raises more troubling concerns related to the proposed use of eminent domain. The proposals would impose losses on mortgage investors, including the retirement and savings accounts of thousands of individual investors, in order to extract profits that would be delivered to a small group of opportunistic investors, with the added value

[4] *See* http://www.fhfa.gov/webfiles/24110/PF_LettertoCong73112.pdf

of guarantees given by Ginnie Mae. This plan is a veiled short-term, opportunistic investment strategy that utilizes federal government insurance and guarantees to achieve its goals.

We offer an example to illustrate the scale of this government-enforced private wealth transfer. Based on documentation we have reviewed and statements by the architects of the MRP plan, a typical transaction may have economics similar to those shown in the table on the next page. This example shows that the proposals would extract profits at the expense of existing security holders and transfer that wealth to the investors and the architects of this scheme. We believe that, on its face, this indicates that the just compensation that is required by both the U.S. Constitution and various state laws would not be provided to the victims of these seizures.

The loss shown in the table represents but one component of the total losses that security holders will suffer, and for which law requires that they be compensated fully; each investor from which a "taking" would be executed must be financially returned to its original position, as though the "taking" transaction were never done, in accordance with explicit doctrine of the U.S. Supreme Court. In addition to the specific loss a securitization trust and its investors (asset managers, pension funds, insurance companies, Fannie Mae, Freddie Mac, FHLBs, etc...) would suffer due to inadequate compensation paid for a specific loan seized from a mortgage pool, trusts and their investors would suffer further losses due to the resulting overall deterioration of the asset quality of the pool. Just as seizing the oceanfront portion of an oceanfront property would significantly devalue the remaining, newly landlocked parcel of land, seizing performing mortgage loans from a trust would increase the concentration of non-performing loans, causing the trust's securities to fall in value. Depending on the volume of mortgages seized, securitization trusts may also incur costs related to adjusting or revaluing hedges and funding mechanisms, and investors would face unanticipated risks from the need to reinvest the unexpected proceeds of eminent domain seizures.

Table 1 – Example of a Loan Seizure

Assumptions

- Loan amount = $150,000
- Home Value = $100,000
- Eminent domain seizure compensation = $80,000 (100,000 x 80%)
- Loan Refinanced into FHA loan at a 97.75% loan-to-value ratio, new loan amount = $97,750
- Proceeds of securitization of refinanced loan: $104,592
    - Assumes GNMA MBS sold into market at $107 price. ($97,750 x 1.07 = $104,592)

Bottom Line for MRP's Investors:

- Gross profit: $24,592 ($104,592 – $80,000 = $24,592)
- over **30%**

Bottom Line for MRP:

- $4,500 per loan

Bottom Line for MBS Investor:

- Gross loss severity: $70,000 (150,000 – 80,000).
- Nearly **47%**

Given the extent of these losses, it is impossible to conclude that the holders of the mortgage-backed securities would be provided with just compensation. Holders of loans would be compensated at a level significantly below the value of the property securing the loans. The valuation would not take into account the actual value of the cash flow from the performing loans in the trust, the diminution of the value of the mortgage pool the loan was taken from (and the corresponding loss in value of the

securitization trust's securities), the ancillary costs of any adjustments to hedges and funding, or the reinvestment risk faced by the holders of the mortgage-backed securities. In other words, the compensation contemplated under this plan is only a fraction of the true loss that would be suffered by the holders of such mortgage-backed securities.

3. Legal Issues with Eminent Domain

We strongly agree with the concern expressed by FHFA regarding the legality of the eminent domain proposals under the U.S. Constitution, state constitutions and other federal and state laws. The U.S. Constitution permits government seizure of private property only if such takings are made for a public purpose in exchange for just compensation; state constitutions and laws governing eminent domain are often equally or even more demanding. As noted above, the likelihood of any material public benefit arising from these proposals is very low, and the fact that the proposals would transfer profits from one private party to another renders the exercise of eminent domain here constitutionally defective. Furthermore, the "takings" by design will not satisfy the requirement of just compensation, both by underpaying for the seized mortgages in order to provide new investors with substantial profits, failing to account for the secondary effects on the value of the mortgage trusts and securities affected, and other included loss factors.

There are other critical legal flaws in the proposal. For example, this use of eminent domain:

- Could be challenged as a violation of the Contracts Clause of the U.S. Constitution;
- May impermissibly burden interstate commerce in violation of the U.S. Constitution's Commerce Clause; and
- Would expose participating municipalities, and taxpayers, to potentially enormous liabilities to existing note holders based on court adjudication of the required "just compensation".

We only briefly mention these legal concerns here, and direct you to review a memorandum on this issue prepared by the law firm O'Melveny and Myers, authored by Walter Dellinger, former Solicitor General of the United States. We have attached that memo to this letter. If these plans proceed, we expect that frequent and costly litigation would quickly follow, on both a preemptive and taking-by-taking basis. We believe that the municipalities being used by the proponents of this plan would be caught in the middle, and forced to bear significant expense and burden. Litigation would also promote uncertainty in mortgage lending and mortgage finance markets, further reducing credit availability in the private mortgage markets.[5]

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We strongly agree with the concerns FHFA expressed in its notice. We believe that FHFA has correctly identified the specific concerns with the program, and agree that it is appropriate for FHFA, and all other

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[5] Eminent domain plans also put the FHLB system at risk. Collateral pledged to the FHLBs to secure advances by member institutions will typically include PLMBS as approved by FHFA. If eminent domain "takings" schemes were to be effected, the price and spread volatility of the returning collateral could become extreme, leaving required collateral coverage constantly doubtful. At best, very large haircuts in collateral values would be required, leaving the financial utility of the system banks weakened.

market participants, to be prepared to act to protect their interests and fulfill their legal duties and obligations. We are most concerned with the broad, negative impact this illegal scheme will have on consumers who depend on the mortgage lending and mortgage finance markets. This impact would be driven primarily by the enactment of an unfair and illegal scheme to seize loans for a private purpose in exchange for severely insufficient compensation. This would shatter all historical precedents regarding eminent domain and weaken the collateralized nature of mortgage lending, causing far more harm than good. It is clear that sound public policy requires that Federal instrumentalities, such as Fannie Mae, Freddie Mac, FHA, and Ginnie Mae, should be prohibited to transacting in any manner with any party seeking advantage from a "takings" plan under authority of speciously invoked eminent domain.

We stand ready to assist FHFA in terms of providing further information, data, or perspectives on this issue.

Sincerely,

American Bankers Association
American Council of Life Insurers
American Escrow Association
American Insurance Association
American Securitization Forum
Association of California Life and Health Insurance Companies
Association of Financial Guaranty Insurers
Association of Mortgage Investors
California Alliance to Protect Private Property Rights
California Bankers Association
California Escrow Association
California Mortgage Association
California Mortgage Bankers Association
California Land Title Association
Community Mortgage Banking Project
Consumer Bankers Association
Consumer Mortgage Coalition
Illinois Bankers Association
Illinois Chamber of Commerce
Illinois Mortgage Bankers Association
Inland Valleys Association of Realtors
Investment Company Institute
Mortgage Bankers Association
Residential Servicing Coalition
Securities Industry and Financial Markets Association
United Trustees Association