Explanation of How Eminent Domain Can Be Used to Restore the Real Estate Market and the Financial System Without the Adverse Consequences to the Current Holders of the Condemned Mortgages

The reason that the real estate market and the financial system have had no appreciable recovery from the effects of the most recent housing bubble is because no method has been proposed that will affect all of the mortgages created during the years of the bubble simultaneously and with equal fairness.

Cornell professor Robert Hockett has discovered a way to do that by using the power of eminent domain. The problem with Professor Hockett's Plan is that he proposes to take the property (the mortgages) with *unjust* compensation, rather than the just compensation that the eminent domain doctrine requires.

The Hockett Plan would pay the current holders of the mortgages only the current market value of the condemned mortgage. In other words, a lender who had loaned $400,000 at some point during the bubble, and who has been repaid $100,000 of the $400,000, would only receive, for example, $150,000 of the $300,000 still owed on the mortgage loan.

Professor Hockett does not offer, as justification for the taking of this money from the lender, that the lenders were greedy, conniving, predatory lenders. He, unlike most other observers of the bubble, explicitly states, and demonstrates, that neither lenders, Wall Street Bankers, regulators, nor raters of investments caused the bubble or the devastation that was caused by the bubble. He, almost alone among those who have analyzed and commented on the bubble, realizes that the bubble was an economic phenomenon that happened to the whole society, with no one more at fault than everybody else.

His justification for taking the money away from those who are entitled to repayment of the money they loaned is that they are in a bad way anyway, and will ultimately be better off if, as a result of their suffering all of the loss created by the occurrence of the bubble, the housing market recovers and brings the general economy along with it.

There are at least three things wrong with that rationale.

1) Everybody else will be advantaged to the same extent as will the lenders, and will have shared none of the loss, so it is unfair.

2) Both logic and the lending community refute the notion that the real estate market will be restored by the government's having shown a willingness and ability to declare that all of the money borrowed with real property as security does not have to be repaid. Who would willingly invest their money if the government can, at some later time, say that they can't get it back?

3) Because of the weight of both of these arguments, there is no chance that Professor Hockett's Plan will be adopted. That will mean that the good part of his plan – that eminent domain powers can be invoked to solve the otherwise unsolvable problem of how to deal with all of the mortgages created during the bubble simultaneously and with equal fairness – will also be discarded.

No other way of restoring the health of the real estate market and the financial system will work. Extensive and expensive piecemeal "bail out" and "stimulus" plans have been repeatedly tried with very limited success.

It is of paramount importance that the discussion of the use of eminent domain to seize the mortgages be changed from a discussion of Professor Hockett's Plan to a discussion of his proposed use of eminent domain, but with *just* compensation.

How can a just compensation be determined?

Mortgages written during the bubble were based upon the bubble inflated *price* of the house. Normally the price for which a house is sold is the true measure of the *value* of the house. That is not true, though, during a bubble.

During the bubble the selling price of the house is made up of two components. One is the value of the house as a place to live in – the same as in normal, non-bubble times. The second is the value of ownership of the house due to its rapidly increasing price.

Professor Hockett expresses that effect in this language:

> When....."real estate and the financial instruments appurtenant to it begin rising in value, for whatever exogenously given reason, at more rapid rates than the effective interest or collateral haircut rates, it quickly becomes rational for more individuals than before to begin borrowing and buying the assets in question."

In my book *Understanding Housing Bubbles* I express it as:

> "A housing bubble is a time period when the fact that the prices of houses is increasing rapidly, *in and of itself*, causes and controls that very increase in house prices."

During the bubble, both of the components of the selling price are used as the basis of the mortgage secured loan. The portion of the selling price that is created by the actual value of the house as a dwelling place exists because of the of factors entirely related to the house itself – its construction values, its location relative to employment opportunities, community development in terms of schools, shopping, transportation, police and fire protection, beauty of location, and all of the things that make up the traditional value of the house.

These things are more or less permanent. The rate of increase in value may vary between 5% and 8% as large employers come and go, or other of the factors affecting the intrinsic value of the house change.

The portion of the selling price of the house that is created by the house having become a commodity which is increasing rapidly in price because of the occurrence of the bubble has nothing to do with the house, but is entirely dependent upon the financial system that supplies the money to inflate the price of the house.

In the most recent housing bubble all restrictions on where money for mortgage backed loans could be obtained had been removed. All political factions favored home ownership for all, regardless of income levels.

Mortgage loans were created that could be obtained by those with very bad credit, but with a very high interest rate. The payments on those loans were made by the borrowers refinancing the loans as the prices of the underlying houses skyrocketed. This ended defaults on mortgages.

Since there were no defaults on mortgage backed loans for many years during the bubble, those agencies whose function was to predict failure rates on mortgage backed financial instruments had to rate those instruments as good quality.

Thus, there was created an investment that paid a very high rate of interest, with no apparent risk of default. It was the existence of this unique investment opportunity that attracted the abundance of available investment capital that Professor Hockett's Plan refers to.

It was these investments, founded on loans on $700,000 houses made to buyers with $40,000 incomes that were highly sought after. So long as the investments were mortgages, bonds backed by mortgage backed loans, and Collateralized Debt Obligations (CDOs) consisting of bundles of mortgage backed bonds, the bubble continued to expand. This enabled the borrowers on these mortgage loans to continually refinance to make their mortgage payments.

Eventually a group of investors became aware of the egregious nature of the mortgages underlying all of these investments. They believed that such bad mortgage loans would inevitably default, and they wished to make money by betting that they would.

This lead to the creation of Credit Default Swaps (CDSs) which were, in essence, insurance policies that would pay off if a mortgage loan or a mortgage backed investment did default.

This divided the financial world into two camps. In one camp were those who looked at the quality of the mortgage and believed that they would default. They bought CDS insurance. In the other camp were those who looked at the default rate on such investments and saw that they never defaulted. They sold CDS insurance.

The Credit Default Swaps did not require the buyer of the insurance to own a CDO, a mortgage backed bond, or a mortgage backed loan. They just required such an investment to be referenced as the basis for the policy.

No money from this transaction went into the housing financing market! The premium payments went from the CDS buyer to the CDS insurer. Any payment in the event of a default on the referenced security went from the CDS insurer to the CDS buyer.

It soon became apparent that these contractual arrangements could be bundled into CDOs in the same manner as the mortgage backed bonds were. Moreover, such CDOs (called Synthetic CDOs) could be created much more quickly and efficiently than could CDOs of mortgaged backed instruments. Synthetic CDOs quickly became popular and took over a lot of the investment money that had previously gone into the house financing market.

Without that fresh investment money, there was no longer money available to continually inflate the price of houses. Therefore, when the borrowers on the mortgage loans sought to refinance their loans in order to make the payments on the loans, they found that they could not borrow more money on their house because the price of the house had not risen. Without funds from a refinance, the borrowers could not make the mortgage payments from the pittance they earned, so they defaulted. This caused prices to drop, and the bubble collapsed.

At that point houses were only worth their value as dwelling places.

The occurrence of the bubble resulted in vast wealth from investments that would normally have increased overall wealth to be diverted into randomly dispersed bestowals of wealth that generally resulted in the wealth being consumed or wasted. The nation and the world are poorer because that happened.

There were no perpetrators of the bubble, and everybody was victimized. It resulted, not from venal design, but from a universally shared failure to understand what was happening.

Nobody has that wealth, enjoying it while others suffer. That wealth was distributed and used in a non productive or wasteful way. It is gone. Lenders don't have the wealth. They, in fact, are the real losers, since they loaned actual money, and haven't gotten it back. Investors don't have it. They, including firemen and school teachers whose pension money was invested in bonds and CDOs that everybody thought were better than gold, are also losers.

It is suggested here that the fairest, most comprehensive way to repair the damage caused by the occurrence of the recent housing bubble is to rewrite all of the mortgage loans made during the bubble to the *value* of the house as a dwelling place *at the time the mortgage loan was made.*

The effect of this action on the various parties involved would be:

- The lenders would be reimbursed for their loss.
- Payments that had been made on the mortgages would be credited against the revised loan amount. This would mean that those who had remained current on the payments on the original loan would have paid ahead on the reduced loan, and perhaps have paid it off. If the amount that had been paid exceeded the amount of the revised mortgage loan, the difference would be returned to the borrower.
- Those borrowers who are in arrears on the original mortgage, but are still in possession of the house, would now owe only on the revised mortgage loan, and would probably not be in

arrears. They might be ahead on payments on the revised loan, and could conceivably have paid off the revised loan.

- Those who had been dispossessed through the foreclosure process, but the house remained unoccupied, would be restored to possession.

The effect on the housing market and the financial system would be that it could function as it was functioning before the bubble occurred, and as it functioned throughout the majority of the twentieth century when homeownership became commonplace. Houses would again be reliable security for money borrowed to purchase them.

Professor Hockett's Plan is appealing because it doesn't require any public money. It has been seen, though, that that is because the money needed to implement the eminent domain solution is unjustly taken from lenders. If that is done, nobody will want to lend money to buy houses. There will be no real estate market. It has also been shown that it is unfair, and doesn't meet the requirement that just compensation be paid to the owners of property taken in an eminent domain proceeding.

The indisputable fact is that it will take public money to implement the public domain solution to the crisis in the housing market and in the financial system.

It was mentioned above that a lot of public money has already been spent in more or less futile efforts to repair the damage to the real estate market and the financial system that resulted from the housing bubble. That money was spent with no real understanding of why and how housing bubbles occur and why they end. They were merely an attempt to simulate a flourishing economy by spending money the way it is spent if the economy *is* flourishing.

Now, Professor Hockett has proposed a tool to be used in a realistic and reasoned approach to the problem.

It happens that, in one of the areas hardest hit by the bubble, Professor Hockett's seeds have taken root, and forward looking community leaders have taken steps to implement the eminent domain plan.

It would seem that, by using money still in the TARP and HARP funds, and money repaid into those funds, a pilot program could be undertaken to test the efficacy of the eminent domain solution. Interest from Chicago, Berkely, and other regions of the country has shown that spending Federal money in search of a solution to problems of such national importance would not be amiss.

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