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San Bernardino County's Loan Seizures Would Destroy Its Mortgage Market Just as Housing Starts to Recover

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The drive to force mortgage investors to refinance loans where the homeowner owes more than the house is currently worth (often know as underwater mortgages) is reaching absurd levels. In the latest example, California's San Bernardino County is exploring using eminent domain to seize certain mortgages and require the investors that own them to accept refinancing that reduces the amount of the mortgage.

Not only would this be a complete misuse of eminent domain,[1] raising substantial constitutional issues and the prospect of years-long litigation, but it would hurt the very people the proposal is supposed to help.

Seizing Mortgages. Eminent domain is usually used to take property that is in the way of a proposed road, government building, or similar project, and it is appropriately limited to appropriations for public use. Under the approach proposed by Cornell law professor Robert Hockett[2] and endorsed by Yale professor and *New York Times* columnist Robert Shiller,[3] the actual property would not be touched, but the mortgage itself that was used to finance its purchase would be seized. Then the mortgage owner (the lender) would be paid the current value of the mortgage as determined by a court-overseen process.

That value is certain to be less than the mortgage's original value, since the property is worth less than it was when the mortgage was first made. The county would then refinance the mortgage for the lower amount plus the cost of refinancing, leaving the homeowner with a mortgage insured by the Federal Housing Administration (FHA) and owing less than the current (lower) value of the house.

Proponents argue that this procedure would enable more homeowners to remain in their houses, since those who owe more than the house is worth are most liable to end up in foreclosure. And by reducing foreclosures, they hope to stabilize neighborhoods, since a foreclosure is likely to result in reducing the property values of the homes around it.

The reality would be very different.

How to Destroy a Mortgage Market. By adding a new level of uncertainty about whether the mortgages will be repaid according to the original contract, future investors would see all mortgage-backed securities as riskier than before and demand that the underlying mortgages be written with even tighter credit standards and higher down payments. Potential homebuyers with lower credit ratings or lower incomes would find either that they cannot obtain a mortgage or that it would cost them more than it would have otherwise.

Potential homeowners in San Bernardino County would be especially affected. As 18 financial trade groups warned in a letter to county officials, "We expect that credit availability for home purchases and refinancing of all San Bernardino loans would be significantly compromised if this plan would be put into effect."[4]

Essentially, faced with the potential that mortgages that they invested in could be seized by county officials, some lenders would stop making mortgages in the county, and others would refuse to securitize mortgages from the area. The 43.4

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percent of San Bernardino County homeowners whose mortgages are underwater[5] would find that they had fewer opportunities to sell their homes as mortgage lenders flee their communities.

Moreover, whatever its ultimate legal merits, the innovation is certainly to be challenged in the courts. Even if the mechanism were to pass judicial muster, it would be months or years before it could be actually used. These challenges would be further fueled because the San Bernardino County program would apply only to mortgages with payments that are up to date—not to any in which the homeowner has fallen behind. It would be harder for the county to say that those homeowners need government intervention since they have been able to make their payments on time.

Furthermore, just as with the many earlier attempts to cause mass refinancing of underwater mortgages,[6] the program appears to promise much more than it would actually deliver. San Bernardino County has an estimated 150,000 mortgages that are underwater.[7] However, county officials say that the program that the county is considering would apply to only about 20,000 to 30,000 of those mortgages,[8] at most 20 percent of the total.

As mentioned, the program would apply only to mortgages that are current, but in addition, it would only apply to mortgages that were securitized by private entities and not those securitized through Fannie Mae or Freddie Mac or mortgages insured by the FHA, which amount to only about 10 percent of the total outstanding nationwide.[9] In short, about 80 percent of the underwater mortgages in San Bernardino County would not qualify because they are either federally insured or because the homeowner is behind on mortgage payments.

Is the Need for Refinancing Passing? Housing activists and government agencies have focused on refinancing underwater mortgages since mid-2007. While their focus was understandable in a weak mortgage market where housing prices were falling, there are now signs that the market is improving in many areas around the country. In the second quarter, asking prices increased in 84 of the largest 100 communities[10] with inventories tightening. Even Las Vegas, one of the hardest hit housing markets, is improving,[11] as are some cities in Arizona,[12] another area where housing prices were severely affected. While full recovery is still far off and could be derailed by another economic downturn, the situation is no longer as dire as it once was.

Given this, it is time to reconsider the need for mass refinancing programs, especially those that must rely upon extraordinary legal

1. See Andrew M. Grossman, "San Bernardino Mortgage Seizure Plan Raises Serious Constitutional Concerns," Heritage Foundation *Issue Brief* No. 3666, July 16, 2012, http://www.heritage.org/Research/Reports/2012/07/San-Bernardino-Mortgage-Seizure-Plan-Raises-Serious-Constitutional-Concerns.
2. Robert Hockett, "Breaking the Mortgage Debt Impasse: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery," Cornell Law School, http://www.lawschool.cornell.edu/spotlights/upload/Memorandum-of-Law-and-Finance-21-April-Municipal-Plan.pdf (accessed July 13, 2012).
3. Robert J. Shiller, "Reviving Real Estate Requires Collective Action," *The New York Times*, June 23, 2012, http://www.nytimes.com/2012/06/24/business/economy/real-estates-collective-action-problem.html (accessed July 13, 2012).
4. Securities Industry and Financial Markets Association (SIFMA), "SIFMA and Other Associations Submit Comments to San Bernardino County on the Joint Powers Agreement of the Homeownership Protection Plan," June 28, 2012, http://www.sifma.org/issues/item.aspx?id=8589939260 (accessed July 13, 2012).
5. Nick Timiraos, "Cities Consider Seizing Mortgages," *The Wall Street Journal*, July 4, 2012, http://online.wsj.com/article/SB100014240527023039334045775 05013392791018.html (accessed July 13, 2012).
6. David C. John, "Obama's New Mortgage Program Is Full of Disappointing Details," Heritage Foundation *Commentary*, November 11, 2011, http://www.heritage.org/research/commentary/2011/11/obamas-new-mortgage-program-is-full-of-disappointing-details.
7. Kate Berry, "Mortgage Investors Protest as California Localities Weigh Seizing Loans," *American Banker*, July 6, 2012, http://www.americanbanker.com/issues/177_130/mortgage-investors-protest-as-california-localities-weigh-loans-1050683-1.html?zkPrintable=1&nopagination=1 (accessed July 13, 2012).
8. Alejandro Lazo, "San Bernardino County Weighs Eminent Domain to Fight Foreclosures," *Los Angeles Times*, July 6, 2012, http://www.latimes.com/business/la-fi-homes-seize-20120706,0,7268655.story (accessed July 13, 2012).
9. Timiraos, "Cities Consider Seizing Mortgages," p. 2.
10. Jed Kolko, "Real Estate Prices Are Going Back Up," *Bloomberg View*, July 8, 2012, http://www.bloomberg.com/news/2012-07-08/brace-yourself-real-estate-prices-are-going-back-up.html (accessed July 13, 2012).
11. Alejandro Lazo, "Las Vegas Housing Market Improves in April," *Los Angeles Times*, May 25, 2012, http://articles.latimes.com/2012/may/25/business/la-fi-mo-vegas-housing-20120525 (accessed July 13, 2012).
12. Vicki Needham, "Housing Market Improves in More Metro Areas," *The Hill*, July 9, 2012, http://thehill.com/blogs/on-the-money/1091-housing/236717-housing-market-improves-in-more-metro-areas (accessed July 13, 2012).

methods, such as questionable uses of eminent domain. The simple fact is that, no matter how supporters tried to bend the rules, most of these programs have actually helped only a relatively small number of borrowers. Even the Federal Housing Finance Agency has resisted mass refinancing and warned of the potential risk of doing so.[13]

Misguided Intervention. The growing recovery of the housing market and the rise in prices that will result from it is far more likely to assist underwater borrowers than any revised or new government program. Rather than raising hopes and expectations that a government effort can never meet, underwater borrowers will actually see their home prices gradually rise with those in the rest of their community. It is true that a full recovery to their home's former value may take years or never come, but this is better than government efforts that would never work in the first place.

Both Congress and government agencies have a long record of "solving" problems about the time that they go away on their own. Mass refinancing programs such as those proposed in San Bernardino County should be dropped.

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13. David John, "DeMarco Warns of the Dangers of Large-Scale Forgiving of Mortgage Debt," The Heritage Foundation, The Foundry, April 15, 2012, http://blog.heritage.org/2012/04/15/demarco-warns-of-the-dangers-of-large-scale-forgiving-of-mortgage-debt.