DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT

STUDY OF WAYS OF RESTORING EQUITY TO UNDERWATER HOMEOWNERS

31 OCTOBER 2015

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PREFACE

Senate Bill 850 (Chapter 561, Acts of 2014), directed the Maryland Department of Housing and Community Development to conduct a study on ways to restore equity to underwater homeowners with private label mortgages. The Department was required to identify and evaluate methods, including the use of eminent domain by local governments, for restoring equity to homeowners who have been unable to obtain mortgage loan modifications that would allow the homeowners to keep their homes.

The Department of Housing and Community Development was instructed to monitor the development of and legal challenges to the use of eminent domain to assist underwater homeowners in other parts of the country, conduct public hearings, and consult with stakeholders in the formulation of this study, and submit the findings of the Department to General Assembly on or before 1 November 2015, in accordance with § 2–1246 of the State Government Article. The Department complied with each of these requirements in the formulation of this report.

INTRODUCTION

The housing crisis of the last decade hit the State of Maryland and Marylanders particularly hard. The past several years, we have seen significant recovery in housing prices, but in many places home values still do not approach what they once did. In these instances, homeowners who purchased at a higher point in the market and were locked into mortgages exceeding the current value of their homes are now said to be "underwater." For those individuals who must sell their homes for a variety of reasons or who are experiencing difficulty in making their mortgage payments, it is desirable to try to assist them however we are able.

BACKGROUND

In the aftermath of the housing bubble burst, state and federal government, as well as lenders, established a number of programs to assist homeowners in need. The State of Maryland, for its part, started the Maryland HOPE Initiative, developed new resources to assist at risk homeowners, expanded consumer education and outreach, passed legislation to prevent and mitigate future foreclosures, expanded activities to engage and inform lenders, and worked with stakeholders to facilitate negotiations to refinance homes.

The subject of use of eminent domain to acquire a mortgage or deed of trust has come up in several jurisdictions around the country, from Newark, NJ to Richmond, CA. While the proposal has passed some legislative hurdles in places, the Department of Housing and Community Development has been unable to find a jurisdiction in which such a plan has been successfully implemented. Meanwhile, the State of Louisiana noted such concerns with the idea, that the Louisiana State Legislature passed an affirmative prohibition on the use of eminent domain for this purpose, not unlike the temporary moratorium passed by the Maryland General Assembly.

ANALYSIS

Though some of this analysis will touch on legal issues, nothing contained herein should be construed as legal advice.

When the Federal Housing Finance Agency (FHFA) studied this issue in 2013, FHFA noted firstly that there are a number of legal concerns ranging from the constitutionality of such a proposal under the takings clause to the prohibitions included in the Housing and Economic Recovery Act of 2008. It is also suggested that seizing a mortgage would have significant impact on the greater housing market and on the sales and transfer of mortgage backed securities. Because mortgage backed securities are traded across state and national boundaries, this action could be seen as a violation of the Commerce Clause of the Constitution, as well.

FHFA also raised concerns about the efficacy of such a program, believing it to be potentially "counter-productive and difficult to assess. In a market where home values are stabilizing and, in some cases, moving upwards, the need for such a program (even if it were merited) appears to diminish" and " the effect of such a program could be to depress artificially the value of homes and lower the tax base for communities and chill lending to support a rising market."[i]

To protect its interests, the FHFA would not rule out the possibility of taking legal action against state or local governments who move to institute a policy of restructuring mortgages via eminent domain. In a statement dated 8 August 2013, FHFA asserts that they may “initiate legal challenges to any local or state action” or direct regulated entities to “limit, restrict, or cease business activities within the jurisdiction of any state or local authority employing eminent domain to restructure mortgage loan contracts” or “such actions as might be appropriate.”

In 2013, a lawsuit was filed with U.S. District Court in San Francisco challenging the government of Richmond, CA in its intention to implement eminent domain seizures of mortgages. The suit was initially dismissed by U.S. District Court as premature, given that Richmond, CA had not moved forward with its much-discussed plan. U.S. District Judge Charles Breyer dismissed the suit saying in his decision that it was based on "future events that may never occur," which would mean "the matter could linger in abeyance for an indefinite amount of time." The plaintiffs, which included Wells Fargo, Pacific Investment Management Co, BlackRock Inc., DoubleLine Capital LP, Bank of New York Mellon, U.S. Bank, and Wilmington Trust, appealed to the U.S. Court of Appeals for the Ninth Circuit, but withdrew in 2014 after it became clear that the City of Richmond would not begin seizures.

Additionally, there are major concerns with the actual cost of such a program as it relates to the fair market valuation of the mortgage being seized. Mortgage Resolution Partners (MRP), the company driving the eminent domain push in Richmond, CA, created a proposal that can be considered the model for this type of action. Under that model, MRP argues that the market value will be determined "the same way the market does for whole loans now, and as juries do for all eminent domain actions: comparable sales in the secondary market, and discounted cash flow analysis."[ii] This valuation does not take into account that loans are generally pooled into securitization trusts that diversify investor risk and reduce losses should loans in the trust stop performing. Therefore, it can be expected that the seizure of a performing loan concentrated in a securitization trust would necessarily devalue the trust as a whole, requiring additional compensation to investors in that trust, under the principles of partial takings.

Legal challenges notwithstanding, there are also practical implications of instituting such a program that would seize mortgages for purposes of restructuring. The institution of such a program would seem to have a dramatic effect on the business model for lenders. It can be expected that the use of eminent domain to acquire a mortgage or deed of trust would result in fewer loans being made in a particular area or significantly higher fees and interest rates to counter the risk to lenders, or both.

Even for homeowners who might benefit from such a program, there may be financially ruinous unintended consequences. Homeowners who receive a restructured mortgage with principal reduction may be subject to provisions of IRS Cancellation of Debt guidelines, where such a benefit could become taxable income. The Mortgage Forgiveness Debt Relief Act of 2007 typically "allows taxpayers to exclude income from the discharge of debt on their principal residence. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualify for this relief." However, this provision only applies to debt forgiven in calendar years 2007 through 2014 and subject to certain other restrictions. It is possible that this provision will be extended by Congress again, but as of the writing of this report, the taxpayer receiving such relief would likely be subject to a greater tax obligation.[iii]

ALTERNATIVES

Private sector alternatives do exist and are working. Principal reduction programs through Community Development Financial Institutions (CFDIs) are one. Under such programs, CDFIs purchase mortgages that are subject to foreclosure and sell the home back to the homeowner under new financing.

One such success story in Maryland is a program called the SUN Initiative (Stabilizing Urban Neighborhoods). The SUN Initiative was launched in 2009 by Boston Community Capital, a 30-year old nonprofit organization.[iv] Boston Community Capital is a Community Development Financial Institution (CDFI) that has invested over $1 billion in projects to help build healthy communities. The SUN Initiative purchases homes or mortgages in foreclosure and sells or refinances them back to the original homeowners or tenants with mortgages they can afford. The program specifically targets individuals and families who can afford homeownership, but are in over their heads with their current mortgage terms. Since the program began, SUN has helped more than 500 families to stay in their homes.

CONCLUSION

The Department recommends that localities carefully consider the externalities associated with the use of eminent domain to acquire a mortgage or deed of trust before proceeding with such an option. Further, the Department would encourage state officials and local leaders to make constituents in need aware of the programs that are currently in existence to assist them.

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[i] Federal Housing Finance Agency, General Counsel Memorandum, 7 August 2013
[ii] Testimony of Robert Hockett, House Financial Services Committee, United States Congress, 11 September 2012
[iii] IRS Publication 4681
[iv] Michelle Singletary, "Boston-based program a worthy alternative to foreclosure," *Washington Post*, 19 October 2014.