



September 7, 2012

BY ELECTRONIC MAIL

Federal Housing Finance Agency

1700 G Street NW

Washington, DC 20552

Attn: Office of General Counsel (OGC) of the FHFA

eminentdomainOGC@fhfa.gov

Re: Official Comments Related to the FHFA Request for Input Regarding the “Use of Eminent Domain to Restructure Performing Loans”

Notice No. 2012-N-11¹

Federal Register Vol. 77, No. 154

Thursday, August 9, 2012/Notices

Ladies and Gentlemen:

SpiritBank appreciates the opportunity to respond to the request by the Federal Housing Finance Agency (hereafter FHFA) for public comment and input related to their Notice of 9 August, 2012 No. 2012-N-11; more specifically the Notice for comment and input related to the “Use of Eminent Domain to Restructure Performing Loans”.

For over 96 years SpiritBank has served its local communities as a source of financing for consumers seeking housing credit. As a state chartered Commercial Bank headquartered in Bristow, OK, SpiritBank epitomizes the mission of all community banks to her friends and neighbors. With 13 branches in 9 communities throughout Oklahoma, SpiritBank has grown to an approximate size of \$1.075 Billion in assets. We believe that our role as a major home lender in Oklahoma through our retail branches as well as our presence through our Secondary Market Mortgage Conduit, American Southwest Mortgage Company, gives us a unique perspective into the various topics shaping our nation’s housing finance markets.

SpiritBank delivers mortgage financing through three distinct channels. The first is our Portfolio Lending channel which originates residential consumer real estate secured loans that are held on the Bank’s books as an ARM. Our other two channels, Retail Secondary Mortgage Lending and Third Party Mortgage Origination Lending, originates traditionally defined “conventional” and “government” loans which are sold to secondary market servicers after closing.

Whether it is the providing of financing for residential developments or the construction loan to build that dream home or the loan to that first time buyer, SpiritBank has been along with our customers on their journey. Thus it goes without saying that SpiritBank’s familiarity with home lending is unique, long-term and deeply ingrained into the Bank’s culture and day to day activities.

¹ Federal Register Notice no 2012-N-11; Vol. 77, No. 154 on 8/9/2012. Found at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-09/pdf/2012-19566.pdf>



To summarize our position on the issue in question, it would be an understatement to say we merely oppose the use of eminent domain to seize and restructure performing mortgage loans. Rather, we are ***emphatically and categorically*** opposed to any proposed use of eminent domain powers by any level of government to seize and restructure performing mortgage loans.

Our opinion is that the exercise of such power in this area of the marketplace is a clear and sobering abuse of constitutional authority in which what can only be described as a near “tyrannical act” is committed against the rights of property owners, specifically the holders of and investors in Mortgage Backed Securities in which the seized mortgages are part of the cash flow. We do not believe that government entities such as the ones currently being formed in San Bernardino County California have a legitimate right and power to seize performing mortgage loans for the purpose of restructuring.

Furthermore this is also an act at the height of folly regarding economic policy as the exercise of such power by an instrumentality of government would further alienate and isolate the geographic area governed by such an authority exercising its condemnation powers. This would be a case of not just “one step forward and two steps back” but frankly just “numerous steps back”.

Our following comments seek to answer the questions that FHFA has asked in relation to the concerns listed in the Notice and in relation to the role of FHFA as conservator of the Enterprises (Fannie Mae and Freddie Mac) and overseer of the Federal Home Loan Bank (FHLB) system. Those questions and areas of comments on which our comments are limited include

- Background on the Use of Eminent Domain with Mortgages;
- Constitutionality of the use of Eminent Domain;
- The General Economic Effect of use of Eminent Domain;
- Questions as to the Need for the use of Eminent Domain;

Background on the Use of “Eminent Domain” & Mortgages

The conceptualization to use the State’s power of eminent domain finds its roots in the world of academia. It is specifically found in what Robert Hockett, a professor at the Cornell School of Law refers to as “recursive collection action problems”².

In short the “theory” endorsed and peddled by Professor Hockett is that debt “overhang” must be cut back which would essentially force the market to “revalue” assets—in this case the price of homes. In essence the good professor is advocating principal write downs.

The problem Professor Hockett explains in this theory is that everyone at the table recognizes and understands that principal reduction is the only way in which to slow foreclosures and put

² ***“It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Economic Recovery”*** Robert C. Hockett, Professor of Law, Cornell Law School in the Cornell Law School Legal Studies Research Paper Series, Paper No. 12-12 found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2038029



the brakes on the issue of sliding real estate prices but nobody wants to be the first to take a step into that brave new world.

The list of parties at the table is seemingly endless—holders of Mortgage Backed Securities (MBS), Servicers, Securitizers, holders of second position liens, et al are acting contrary to their own “best interest” as Professor Hockett explains³. He describes fragmentation of ownership interests and the inability to orchestrate collective action among the different parties. Thus we have the concept of “recursive collection action problems”.

Professor Hockett and others are proposing to use a centralized collective agent that is authorized to coordinate and conduct all the different parties involved towards their goal of principal reductions.

That “collective agent” proposed as the solution then, is the power of the state to exercise its authority of eminent domain.

Questions of Constitutionality Related to Eminent Domain

The Fifth Amendment to the United States Constitution establishes the privileges and protections afforded to all persons as relates to the power of the government to seize private property.

Specifically in relation to this power the last sentence reads:

“nor shall private property be taken for public use, without just compensation.”⁴

The idea of “takings” has developed throughout American Jurisprudential History. In 2005 a split (5-4) United States Supreme Court expanded the meaning of “**public use**” in its landmark decision *Kelo v. City of New London*⁵.

In *Kelo*, the Court held that the state exercised seizure and transfer of private property from one citizen to another was a valid exercise of eminent domain authority in so far as the benefits of economic development were considered a valid “**public use**” in that a “**public purpose**” was served. Justice Stevens the author of the Majority Opinion writes:

“Accordingly, when this Court began applying the Fifth Amendment to the States at the close of the 19th century, it embraced the broader and more natural interpretation of public use as public purpose.. See, e.g., Fallbrook Irrigation Dist. v. Bradley, 164 U. S. 112, 158.164 (1896).”⁶

Supporters of this plan to use eminent domain to seize *performing* mortgage notes on homes with negative equity positions (i.e. “underwater”) argue that the public purpose that is being met is essentially the **stabilization of residential housing market values** that would naturally occur

³ See Footnote # 2 above at page 17 of 56 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2038029

⁴ United States Constitution found at http://www.law.cornell.edu/constitution/fifth_amendment

⁵ *Kelo v. City of New London* (545 U.S. 469 (2005) at <http://www.law.cornell.edu/supct/html/04-108.ZS.html>

⁶ *Kelo* at Page 9 found at <http://www.law.cornell.edu/supct/pdf/04-108P.ZO>



from the reduction in foreclosures that would *possibly occur* (remember the notes ARE performing when they are condemned and seized.)⁷

In other words, the seizure of the mortgage notes at the value of the property (less than the current outstanding principal owed) would be a *de facto mortgage cram-down*. Cram-down is a concept that has been rejected by the United States Congress several times in recent history including most recently during a vote in the United States Senate when 12 members of the majority party crossed over to vote against giving cram-down principal reduction authority to bankruptcy judges.⁸

We believe there would still be much constitutional scrutiny to any plan to use eminent domain to seize performing mortgage notes. We turn to Justice Anthony Kennedy's concurring opinion in *Kelo* where he says:

"The determination that a rational-basis standard of review is appropriate does not, however, alter the fact that transfers intended to confer benefits on particular, favored private entities, and with only incidental or pretextual public benefits, are forbidden by the Public Use Clause."⁹ (Emphasis added)

The plan in question by San Bernardino County California rests on the ability of the government entity to seize performing mortgage notes at a discount to the actual principal amount owed and then transfer ownership to a different entity. Such an action would be questionable at the very least and most likely a violation of the rationale in *Kelo*.

According to SFGate.com, a Hearst Communications Company, in their story of August 5, 2012 it is clear that the Mortgage Resolution Partners, the private consultant firm in this proposal stands to gain. The story says of the plan:

"Even at first glance, too many things about it seem suspicious. The idea is that local authorities could use their powers of eminent domain to buy privately held, underwater mortgages, reduce the principal amounts on those mortgages, and then transfer them to a new entity. For its consulting and middleman skills, Mortgage Resolution Partners would make a tidy profit of \$4,500 per mortgage."

When we dug into the details of the plan, however, it became clear that this is a great deal for Mortgage Resolution Partners and not so great for anyone else."¹⁰ (Emphasis Added)

⁷ "Solving the Foreclosure Crisis Through the Exercise of Eminent Domain" Jeremy Kennedy Thornton, JD Candidate Spring 2010 University of Notre Dame Law School at Page 8 found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1560032&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1560032

⁸ "Obama Housing Fix Falter on Carrots- Not Sticks Policy" by Clea Benson, Bloomberg June 10, 2012 found at <http://www.bloomberg.com/news/2012-06-11/obama-housing-fix-faltered-on-carrots-not-sticks-policy.html>

⁹ *Kelo* Concurring Opinion by Justice Anthony Kennedy at page 1 found at <http://www.law.cornell.edu/supct/pdf/04-108P.ZC>

¹⁰ "Eminent Domain Risky for Mortgage Relief" August 5, 2012 found at <http://www.sfgate.com/opinion/editorials/article/Eminent-domain-risky-for-mortgage-relief-3764468.php>



But not just federal law is an issue here—there is also a case to be made based on the California State Constitution. Article 1, Declaration of Rights, Section 19 is the enabling language for the establishment of citizens’ rights and protections under eminent domain proceedings. It reads:

“(b) The State and local governments are prohibited from acquiring by eminent domain an owner-occupied residence for the purpose of conveying it to a private person.”¹¹

While in this specific case and context the state is not acquiring the private property, it is acquiring an indirect interest in the borrower’s private party vis a vis by condemnation of the mortgage note. At the very least it raises again questions as to the beneficial interest that is gained by a private party through the condemnation action.

Further there is the question of “just compensation”. Most legal opinions and court case law state that to meet the burden of the Taking’s Clause’s “just compensation” requirements that valuation must occur based on *fair market value*.¹²

California State Statute says:

“Compensation shall be awarded for the property taken. The measure of this compensation is the fair market value of the property taken.”¹³

If a performing mortgage note is to be properly valued in the market today it is more than likely that it is valued at or above the principal balance owed as the loan itself is performing. By seizing that mortgage note and awarding a value that is less than the principal balance owed and justifying it based upon the value of the underlying real property would be an arbitrary and capricious act on the part of the state and thus a real potential violation of state and federal law.

A performing mortgage would most likely be valued at least as much or more than the principal balance owed. However the basic principal in play is that the value of the performing mortgage note is independent of the value of the underlying property.

As an example of another intangible property—would a government entity be able to condemn stock in a company seizing it for the book value, say \$25 a share, when the market has the company valued at \$40 a share in the open market?

This raw exercise is an overreach of state power and authority. We would also reference the excellent piece by Robert Barnett of Barnett, Sivon & Natter, PC as published in their firm’s

¹¹ Constitution of the State of California found at http://www.leginfo.ca.gov/const/article_1

¹² See Footnote # 10 in The Heritage Foundation’s Issue Brief No. 3666 July 16, 2012 ***“San Bernardino Mortgage Seizure Plan Raises Serious Constitutional Concerns”*** by Andrew M. Grossman found at http://thf_media.s3.amazonaws.com/2012/pdf/ib3666.pdf

¹³ California Code of Civil Procedure Part 3 Title 7, Chapter 9, Article 4, §1263.310 found at <http://codes.lp.findlaw.com/cacode/CCP/3/3/7/9/4/s1263.310>



“*Our Perspectives*” dated July 2012. Mr. Barnett lays out the legal hurdles that the San Bernardino County Authority would face in attempting to implement such a program.¹⁴

The Economic Effects Related the Use of Eminent Domain

The economic effects and impacts cannot be understated if the state were to exercise a use of eminent domain authority to seize performing mortgage loans.

The most immediate and long term impacts would include the creation of yet another level of unpredictability and risk into credit markets. Prices which find their expression in the yields of mortgage backed securities and thus interest rates paid by the consumer would reflect the new reality of this risk. We would expect prices on MBS generally to decline and thus yields/interest rates would rise.

Once again we turn to Mr. Barnett who writes with splendid prescience:

“Even if all these hurdles, and others not raised, are overcome, there is one serious problem remaining. At the end of the day, this program has elevated real risk in any future secondary offerings that might be made. Even if the loans are held in portfolio, this new risk must be considered. Lenders will of necessity now be forced to try and calculate that risk and to price it into the loans.”¹⁵

The impact at this point is hard to quantify with great specificity except to say that there will be a detrimental impact. A Bloomberg story from July 13, 2012 references Amherst Securities Group, LP Analyst Laurie Goodman who testified before Congress on June 7. The story says:

“Mortgage Resolution Partners has told potential investors that it will target paying 75 percent to 80 percent of a home’s market value for the mortgages seized through eminent domain, Goodman wrote in a report.”¹⁶

The more immediate impacts would be upon the geographic area exercising eminent domain authority to seize performing mortgage notes. Investors in Mortgage Backed Securities would demand a “geographic eminent domain risk” premium for areas where mortgage notes stood a greater chance of being condemned.

Most impacted of course would be the homeowners and real estate investors in the Sand Bernardino County area where this action is being contemplated. They would be seen as having a greater risk of future action should the authority there exercise condemnation powers on mortgage notes.

¹⁴ “*The San Bernardino Eminent Domain Solution*” , Robert Barnett, July 2012 found at http://www.bsnlawfirm.com/newsletter/OP0712_Barnett.pdf

¹⁵ See Footnote # 14 above- Same Source at Page 5 found at http://www.bsnlawfirm.com/newsletter/OP0712_Barnett.pdf

¹⁶ “*Bondholders See Eminent Domain as State Attack: Mortgages*” by Jody Sheen and John Gittelsohn, Bloomberg July 13, 2012 found at <http://www.bloomberg.com/news/2012-07-13/bondholders-see-eminent-domain-as-state-attack-mortgages.html>



David C. John of the Heritage Foundation writes:

“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.”¹⁷

In attempting to help the homeowners of their county, government officials will actually do more harm than good in terms of addressing the foreclosure issue on homes with “underwater” equity positions.

The Need for Eminent Domain?

There is also the practical argument to be made that use of eminent domain is the proverbial “day late and a dollar short” or is the “solution in search of a problem”. By this we mean that there is evidence that real estate markets have perhaps reached the bottom already and that fewer underwater loans are actually defaulting.

Jody Shenn with Bloomberg writes:

“Local governments from New York to California are increasingly considering plans to seize mortgages to protect their housing markets against homeowners abandoning properties with values below what they owe.

They may be a year too late. Data on the loans municipalities are being advised to target show fewer underwater mortgages are defaulting and when borrowers stop paying, modifications increasingly include balance cuts. The number of Americans with negative equity is also falling as housing recovers from its worst slump since the 1930s, [Chris Katopis](#), head of the [Association of Mortgage Investors](#), said at an Aug. 14 hearing held by a [Chicago city council](#) panel.”¹⁸

One of the most closely watched indices- the Case-Shiller Index announced just a little over one week ago that home prices across the US rose in the Second Quarter of 2012.¹⁹ For California alone the FHFA’s own data shows that there was approximately 4.13% appreciation across the state in Q2 of 2012.²⁰

Other evidence from this year shows increases in the Golden State. The LA Times reported on July 19, 2012 that there were increases in California housing prices as measured by DataQuick a

¹⁷ ***“San Bernardino County’s Loan Seizures Would Destroy Its Mortgage Market Just as Housing Starts to Recover”*** David C. John. The Heritage Foundation Issue Brief No. 3665 July 13, 2012 on page 1- See also Footnote # 4 in the article. Found at http://thf_media.s3.amazonaws.com/2012/pdf/ib3665.pdf

¹⁸ ***“Cusack Spars with Pimco on Underwater Mortgages as Risk Recedes”*** Jody Shenn Bloomberg found at <http://www.sfgate.com/default/article/Cusack-Spurs-With-Pimco-On-Underwater-Mortgages-3796076.php>

¹⁹ Found at <http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldocumentfile&blobtable=SPComSecureDocument&blobheadervalue2=inline%3B+filename%3Ddownload.pdf&blobheadername2=Content->

<Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1245339137830&blobheadervalue3=abinary%3B+charset%3DUTF-8&blobnocache=true>

²⁰ <http://www.fhfa.gov/Default.aspx?Page=215&Type=compare&Area1=CA&Area2=&Area3=>



San Diego real estate firm. Specifically the author, Mr. Alejandro Lazo references Southern California real estate markets' improvements. Mr. Lazo writes:

“In Southern California, the median home price rose to \$300,000, up 1.7% from May and 5.3% higher than in June 2011. Sales in the Southland — 22,075 — fell 0.5% compared with May but were 7.5% higher than a year earlier.”²¹

When faced with this data it becomes highly questionable as to whether government entities should provoke further potential market disruptions from occurring which would naturally emanate from the use of eminent domain authority as proposed in the San Bernardino case.

Concluding Remarks

In conclusion we would turn to Acting Director Edward J. DeMarco's comments before The Brookings Institution on April 10, 2012. Director DeMarco's address entitled “Addressing the Weak Housing Market: Is Principal Reduction the Answer?” clearly makes the case for why principal reduction enhances moral hazard and skews incentives for those who may be underwater but still current on their housing payments.

In speaking of current underwater borrowers, Director DeMarco said:

“Encouraging their continued success could have a greater impact on the ultimate recovery of housing markets and cost to the taxpayers than the debate over which modification approach offered to troubled borrowers is preferable. A key risk in principal forgiveness targeted at delinquent borrowers is the incentive created for some portion of these current borrowers to cease paying in search of a principal forgiveness modification.”²²

Whether by forced principal reductions, bankruptcy cram-downs or the coercive power of the state under the guise of a laughable “takings”—the impacts and risks created by incentivizing performing mortgages to cease paying would be a disaster for an already fragile housing market.

I remain—

Cordially,

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²¹ “California Home Prices Move Up” Alejandro Lazo, Los Angeles Times July 19, 2012 found at <http://articles.latimes.com/2012/jul/19/business/la-fi-home-sales-20120719>

²² As found on FHFA's website at http://www.fhfa.gov/webfiles/23876/Brookings_Institution_-_Principal_Forgiveness_v11R-final.pdf