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Should Uncle Sam Seize Mortgage Securities?

Democrats are clear about this much: They believe the banks and the Bush administration have done too little to halt home foreclosures and they intend to do more.

The source of the funds is clear too. House Financial Services Chairman Barney Frank, D-Mass., has warned Treasury Secretary Henry Paulson that Congress won't release the last $350 billion of the $700 billion "Troubled Asset Relief Program" to the Treasury until there's an agreement some of the funds will be used to reduce the estimated 4 to 5 million foreclosures that would otherwise occur over the next two years.

What's less obvious is how the TARP funds can best be used to forestall foreclosures.

One of the more dramatic proposals comes from Howell E. Jackson, a Harvard law professor and expert on both federal budget policy and financial regulation.

He says Congress should authorize TARP to invoke the government's power of eminent domain for the "forced purchase" of distressed mortgage loans and mortgage securities in areas that have seen the largest declines in home prices. Uncle Sam would then own the mortgages and could offer borrowers better terms–say a lower interest rate or stretched out payments–to forestall foreclosures.

One of the problems slowing private sector efforts to work out loans and head off foreclosures is that many troubled mortgages were put in pools, then sliced and diced and sold off as exotic securities known as collateralized debt obligations.

When a bank or a savings and loan owns all of a mortgage, it can, in theory, work with borrowers to modify loan terms. But securitized loans are owned by many different trusts. Getting all those owners to agree to a workout with a single borrower is a legal and logistical quagmire.

Indeed, earlier this month, investors in mortgage-backed securities sued Bank of America over the bank's October agreement with state attorneys generals to work out as many as 400,000 mortgage loans made by Countrywide Financial to settle accusations of past predatory lending practices. (Bank of America acquired Countrywide this past summer.)

The investors' suit, which seeks to be certified as a class action on behalf of the owners of 374 different securities trusts, estimates that the workouts will reduce payments on the mortgages by $8.4 billion, diminishing the value of the mortgage securities by much more. The suit demands that the bank buy out the owners of any loans it modifies, paying securities holders 100% of the mortgage balance plus an unpaid, accrued interest. Bank of America said in a statement at the time the suit was filed that the interests of securities holders were taken into account in its deal with the states and that it is "confident any attempt to stop this program will be legally unsupportable."

process.

That's why Jackson says the government needs to use eminent domain. Treat toxic mortgages like any other property that is in the way of a government project, he says. If a homeowner doesn't agree to sell his house to make way for a highway or some urban renewal project, the government "condemns" the property, takes ownership and pays the owner what it deems to be fair market value.

What's fair market value? Truth is, no one knows what most of these mortgages are worth, which is why the Treasury, in its original plan (since abandoned), suggested a novel (and skeptics said untested) reverse auction mechanism to arrive at a price.

In Jackson's plan, the government could simply seize mortgage securities and pay what it believed to be their fair market value. As in normal eminent domain actions, if the ex-owners thought they'd been paid too little, they could seek judicial review, a process that could drag on for years.

Reaction to Jackson's plan? "Holy cow," says Mark Zandi, chief economist at Moody's Economy.com. "Seizing assets held in trust seems over the top to me." He believes the owners of troubled mortgages would be happy to sell them if they could agree on what their net present value is. "At some point, the government and the markets will do that," he says.

Not surprisingly, Terence Pell, an attorney at the Center for Individual Rights, is similarly skeptical. "This would be telling a judge and a few clerks to figure out what no one else has been able to figure out," he says. "I wonder if the Treasury secretary is willing to spend the rest of his life in court," he adds.

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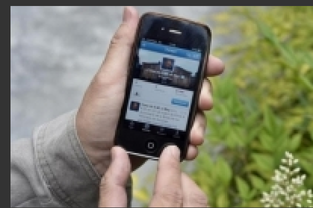

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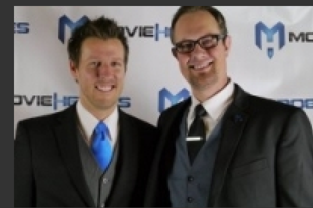

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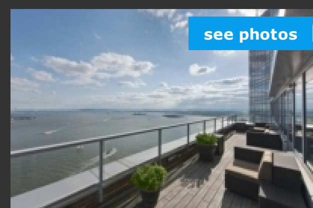

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