EMINENT DOMAIN

A TOOL TO PROTECT HOMEOWNERS AND CITIES

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For decades, local governments have used the power of eminent domain to evict low-income residents across the United States. Reversing this trend of government-sanctioned displacement, the City of Richmond, California has developed an innovative use of eminent domain to keep residents in their homes and prevent foreclosure. By using the power of eminent domain to purchase underwater mortgages developed during the housing bubble at today's market value, Richmond could save residents thousands of dollars and allow them to stay in their homes. This approach has met with strong resistance from Wall Street, where these mortgages have become profitable investment vehicles. Richmond's success will be based on the City's ability to develop new partnerships with activists and investors outside the municipal boundaries.

American cities and millions of Americans continue to face challenges caused by the Great Recession. Foreclosures evict families from their homes, inflict blight on neighborhoods, and cut city revenues that provide basic services. To stem this tide, the City of Richmond, California is attempting to use eminent domain to purchase underwater mortgages, refinance the houses at current values, and keep the city's residents in their homes. However, Richmond has faced strong resistance from Wall Street, which has converted those mortgages into profit-generating investment vehicles. If Richmond and other cities working for their residents are to succeed in the future, they must develop new partnerships outside of their city limits.

THE PROBLEM:

UNDERWATER MORTGAGES, FORECLOSURES, AND AMERICAN CITIES

Seven years after the beginning of the Great Recession, American cities continue to deal with its aftermath. One of the most significant challenges for cities and homeowners has been the loss of housing values. Almost a quarter of all homes with a mortgage, nearly eleven million, are "underwater – meaning that the balance on the mortgage exceeds the current value of the home" (Hockett, 2013, p. 1). Foreclosures have increased as homeowners continue to make payments on peak housing prices while facing unemployment and wage cuts. Across the country, three million homeowners are in the foreclosure process, with an additional 7.5 million expected to enter foreclosure in the near future (Hockett, 2013).

While the problems of underwater mortgages and foreclosures are national in scope, they have been concentrated in a few municipalities, "most notably [in] California, which in 2011 boasted ten of the nation's top twenty municipal foreclosure rates" (Friend, 2013, p. 26). For example in San Bernardino County, near Los Angeles, housing prices fell by half from their high in 2006, leaving over fifty percent of the mortgages underwater (Friend, 2013). In Richmond, California, the focus of the case study, housing values decreased by over sixty percent, leaving nearly a third of the mortgages underwater. This caused 16 percent of homeowners to lose their homes through foreclosure (Dewan, 2014).

Unsurprisingly, the scale of the loss of housing values and foreclosures has had a significant impact on municipalities and their residents. As housing values dropped and foreclosures rose, local property tax revenues have fallen (Hockett, 2013). This has led municipalities to cut services, consolidate school districts, and, in some cases, file for bankruptcy, as San Bernardino County did in August of 2012 (Friend, 2013; Hockett, 2013). Residents who have been able to keep their homes face abandoned neighborhoods, decreased housing values caused by blight, and increased crime (Hockett, 2013), (Friend, 2013).

The logical response to underwater mortgages for cities, homeowners, and the banks that provided the loans is the reduction of principal. Reducing the principal of the mortgage has been more effective in preventing defaults than extending the mortgage's term or reducing the interest rate (Friend, 2013). Since banks are aware of the high rates of foreclosure associated with underwater mortgages, "they find it financially rational to write down these loans" to prevent homeowners from foreclosing (Hockett, 2013, p. 3).

However, nearly ten percent of the mortgage market – $1 trillion – takes the form of private-label securitization (PLS) mortgages, which are structured to make principal reduction difficult (Friend, 2013; Hockett, 2013). After the banks loaned to homeowners, the PLS mortgages

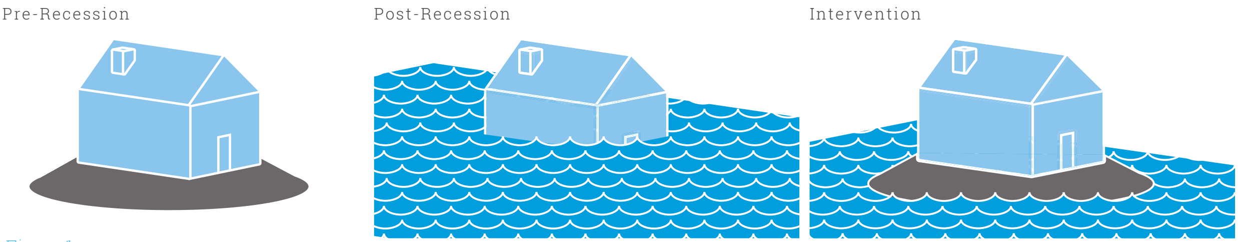

Figure 1

2006 - Peak housing prices: $300,000 market value, $300,000 mortgage.

2013 - Underwater with high risk of default: $190,000 market value, $300,0000 mortgage.

2013 - Eminent domain to refinance mortgage: $190,000 market value, $190,000 mortgage.

were "split into countless pieces and made into bonds," which become investment vehicles on Wall Street (Friend, 2013, p. 27). Any reduction of principal requires agreement by a supermajority of investors, who have no way of communicating with each other (Hockett, 2013; Friend, 2013). Additionally, the banks who manage the mortgages for the investors are prohibited from reducing the mortgage's principal independently (Hockett, 2013). This presents a huge problem for municipalities, since PLS mortgages "are about three times as likely as other kinds to default" (Friend, 2013, p. 27).

THE INTERVENTION:
EMINENT DOMAIN

Fortunately, cities faced with toxic PLS mortgages and foreclosures have a solution – "take definitive ownership" of the mortgages through the power of eminent domain (Friend, 2013, p. 27). Municipalities and counties can use eminent domain to purchase "the underwater mortgages at below the home's market value and to refinance them at lower rates" (The Economist, 2014). By reducing the principal of the loan from the pre-recession peak price to the current market value, cities can significantly reduce owners' monthly mortgage payments. For example, by reducing the mortgage of a house that sold in 2006 for $300,000 to its current value of $190,000, a homeowner could save $700 a month or $8,400 a year, significant savings for a homeowner (Friend, 2013). The investors who purchased the PLS mortgages would receive 80 percent of the fair market value, a higher return than default and foreclosure would bring (Friend, 2013).

To limit the municipality's expenses, it could use federal or private funds to purchase the underwater mortgages (Hockett, 2013). In the case of Richmond, Mortgage Resolution Partners (MRP) gathered $400 million from private investors to purchase the underwater mortgages (Friend, 2013). Investors purchased mortgages at 80 percent of the current market value and refinanced them at 100 percent of the home's fair market value – gaining a 20 percent profit (Friend, 2013).

Continuing the preceding example, the municipality would purchase the mortgage for a house with a peak value of $300,000 and a current value of $190,000 for 80 percent of its current value, at a price of $152,000, and then refinance at its current value, resulting in a 20 percent profit, or $38,000. One-third of the profits would go to the city, one-third to investors, and the remainder would cover MRP's fees and closing costs (Friend, 2013). Current investors in PLS mortgages would be invited to participate in the purchase of underwater mortgages to help them "recoup presently lost value" by the threat of foreclosure (Hockett, 2013).

HISTORY AND PRECEDENCE

Academics, politicians, and investors have proposed the use of eminent domain to purchase underwater mortgages. Robert Hockett of Cornell Law School argued in the Federal Reserve Bank of New York's *Current Issues in Economics and Finance* that condemning purchases using eminent domain is both legally and financially prudent (Hockett, 2013; The Economist, 2014). In 2008, Republican presidential candidate John McCain argued for using "$300 billion in federal bailout money to buy troubled mortgages and write them down" (Dewan, 2014). Futhermore, the founders of Mortgage Resolution Partners had extensive history on Wall Street working for Credit Suisse and Zurich Financial services before deciding "to use their financial fluency to restore millions of people's balance sheets" (Friend, 2013, p. 29).

Legally, there is a long history of using eminent domain to purchase forms of intangible property, such as "bond tax exemption covenants, insurance policies, corporate equities, other contract rights" (Hockett, 2013, p. 4). Additionally, the use of eminent domain has always been tied to "preventing more foreclosures, blighted properties, revenue base losses, and city service cutbacks," which purchasing underwater mortgages aims to achieve (Hockett, 2013, p. 6). In the broader American legal context, bankruptcy facilitates debt reduction, which allows entrepreneurs to launch businesses and firms to recover lost value (Hockett, 2013).

KEY ACTIONS AND CHALLENGES IN RICHMOND, CALIFORNIA

In 2013, the working-class, predominantly Hispanic and African-American City of Richmond continued to feel the effects of the recession with almost a third of its mortgages underwater (Dewan, 2014). Faced with this continuing crisis, Mayor Gayle McLaughlin and her progressive city council, who had already decriminalized homelessness and supported the rights of illegal immigrants, began discussions with Mortgage Resolution Partners to use their funds to purchase the underwater mortgages and help keep residents in their homes (Dewan, 2014). As a result, in July of 2013 Richmond offered 80 percent of current market value to the investors in 624 private-label security mortgages before beginning the process of purchasing the mortgages through eminent domain (Dewan, 2014; The Economist, 2014).

> *Nearly ten percent of the mortgage market is private-label securitization mortgages, which are structured to make principal reduction difficult and are three times more likely to default.*

With incredible speed, national opposition to the purchase of 624 mortgages developed. In August of 2013, large asset-management firms, including BlackRock and PIMCO (which managed investment in bonds containing private-label security mortgages) and their trustees, Wells Fargo and Deutsche Bank sued to prevent the use of eminent domain (Dewan, 2014). Homeowners with underwater mortgages are at risk of defaulting, but as long as owners continue to make high payments based on peak housing prices, they help keep the bonds formed from slivers of PLS mortgages afloat (Friend, 2013). In the case of Richmond, the asset-management firms argued that more than half of the 624 homeowners were current on their mortgage payments (Dewan, 2014). If the city went ahead and purchased those loans at 80 percent of current market value, not only would the investors lose money, but they would also lose future payments that would support the bonds. If Richmond's use of eminent domain were to set a national precedent, Wall Street feared that investors would no longer trust bonds containing PLS mortgages (Friend, 2013), reducing the bonds' values and depriving asset-management firms of a profitable vehicle to offer their investors. However, since the city had not yet used eminent domain to purchase the houses, the federal court rejected the investors' suit as premature (The Economist, 2013).

Beyond litigation, opponents moved to block the city's access to private and federal money. The Securities Industry and Financial Market Association (SIMFA), which promotes investment in bonds containing PLS mortgages, complained to the city's bond underwriter that an upcoming plan to refinance municipal bonds "did not adequately disclose the risks of the mortgage plan" (Dewan, 2014). The city's subsequent attempt to refinance its municipal bonds in August, 2013 received no buyers, despite the bonds' high rating (Dewan, 2014). Discouraging buyers from purchasing municipal bonds could limit Richmond's ability to fund public projects in the future. Additionally, SIMFA is working to persuade Congress to prevent federal guarantees for any new mortgages made in a municipality that has authorized the use of eminent domain to purchase underwater mortgages (Dewan, 2014). This could significantly decrease the value of Richmond's homes, as banks avoid making loans not backed by the federal government to prospective buyers.

In the face of this strong resistance, which had stymied a similar effort in San Bernardino, Richmond officials partnered with Alliance of Californians for Community Empowerment (ACCE) to engage residents and build public support (Dewan, 2014). The city of Richmond and ACCE also reached out to unions, including the Service Employees International Union, which saw many of their members trapped in underwater mortgages (Dewan, 2014). This coalition-building and grassroots campaign helped motivate over 100 residents to speak out at a September city council meeting, where the city held the first of many votes needed to approve the use of eminent domain, which passed with four of the seven council members' votes (Dewan, 2014). However, since California law requires a super-majority to pursue eminent domain, Richmond is considering partnering with a

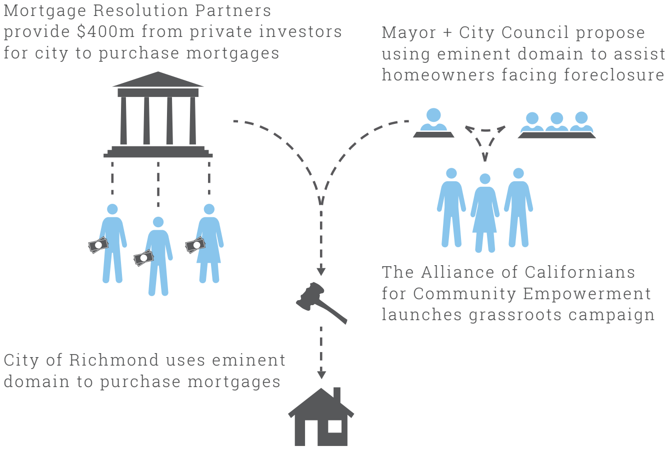

Figure 2
The City of Richmond used eminent domain to purchase mortgages and refinance at current market values. Refinanced mortgages significantly reduce payments, helping more than 600 homeowners avoid foreclosure.

neighboring city to form a joint powers authority with eminent domain powers that could be formed with a simple majority (The Economist, 2014; EfficientGov, 2014). If successful, Richmond's use of eminent domain to protect homeowners may inspire cities across California and across the country to follow suit (The Economist, 2014).

IMPLICATIONS AND ANALYSIS

The conflict surrounding Richmond's use of eminent domain can be understood as a clash between the use and exchange value derived from property. Real estate can provide both values at the same time, often to two different groups. For example, renters derive use value from living in an apartment, while the owner derives exchange value from the rent that the apartment earns (Logan & Harvey, 1987). In the case of Richmond, homeowners derive use value from living in their homes, in intact neighborhoods and with access to good schools and work. By contrast, banks, investors, and asset-management firms derive exchange value from the monthly payments those homeowners make on their mortgages. As the struggle over the mortgages in Richmond has illustrated, "the simultaneous push for both [exchange and use values] is inherently contradictory and a continuing source of tension, conflict, and irrational settlement" (Logan & Harvey, 1987, p. 2).

Previously, that conflict played out in a limited geographic area, as residents deriving use value and entrepreneurs or investors deriving exchange value lived in the same neighborhood, city, or region. However, in Richmond, homeowners still derive use value from living in a specific location, while investors in PLS mortgages live all across the country and even across the world. This means, first, that investors are less concerned with the fortunes of a local community than property owners were in the past. Second, since investors collectively do not live in a specific location inside municipal boundaries, it is more difficult for a city to compel them to protect the use value of homes than in the past. Instead, investors can compel cities to action (or inaction) by controlling their access to capital, as demonstrated by the investors' successful effort to thwart Richmond from refinancing their municipal bonds.
This means that for cities to serve their citizens, they will need to develop new partnerships outside city limits. One of these partnerships will be, paradoxically, with these same investors. While it is easy to criticize those who pursue exchange value, the American legal structure protects and promotes that pursuit. So the effort of Mortgage Resolution Partners to gather private funds to buy mortgages gives Richmond the opportunity to present the use of eminent domain to Wall Street not as a threat, but as an investment opportunity. If enough investors find the purchase of underwater mortgages profitable, asset-management firms, like BlackRock, may stop suing the city and instead start buying the mortgages themselves. This would allow Richmond to promote its residents' use value, while not threatening investors' exchange value.

Other partners include groups like Alliance of Californians for Community Empowerment (ACCE), which can work across city and state boundaries to promote use value in specific communities. By providing cities like Richmond support and knowledge, ACCE's members can help empower residents to speak out and support local officials in the face of national opposition. Their connections across city and state lines can help spread the work of Richmond to other communities that are working to help residents. This means that even if the use of eminent domain is defeated in Richmond, it could emerge stronger and wiser in another community, which will finally succeed in protecting the use value of residents and keeping homeowners in their homes. ■

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