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Mortgage Debt and the Looming Foreclosure Crisis: As the Fed Runs Out of Bullets, Local Governments Are Stepping In

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Mortgage debt overhang from the housing bust has meant lack of middle-class spending power and consumer demand, preventing the economy from growing. The problem might be fixed by a new approach from the Fed. But if the Fed won't act, counties will, as seen in the latest developments on eminent domain and litigation over MERS.

Former Assistant Treasury Secretary Paul Craig Roberts wrote on June 25th that real US GDP growth for the first quarter of 2014 was a negative 2.9%, off by 5.5% from the positive 2.6% predicted by economists. If the second quarter also shows a decline, the US will officially be in recession. That means not only fiscal policy (government deficit spending) but monetary policy (unprecedented quantitative easing) will have failed. The Federal Reserve is out of bullets.

Or is it? Perhaps it is just aiming at the wrong target.

The Fed's massive quantitative easing program was ostensibly designed to lower mortgage interest rates, stimulating the economy. And rates have indeed been lowered – for banks. But the form of QE the Fed has engaged in – creating money on a computer screen and trading it for assets on bank balance sheets – has not delivered money where it needs to go: into the pockets of consumers, who create the demand that drives productivity.

Some ways the Fed could get money into consumer pockets with QE, discussed in earlier articles, include very-low-interest loans for students and very-low-interest loans to state and local governments. Both options would stimulate demand. But the biggest brake on the economy remains the languishing housing market. The Fed has been buying up new issues of mortgage-backed securities so fast that it now owns 12% of the mortgage market; yet housing continues to sputter, largely because of the huge inventory of underwater mortgages.

According to Professor Robert Hockett, who originated a plan to tackle this problem using eminent domain, 40% of mortgages nationally are either underwater or nearly so, meaning more is owed on the home than it is worth. Seventy percent of homes that are deeply underwater wind up in default.

Worse, second mortgages are due for a reset. Over the next several years, principal payments will be added to interest-only payments on second mortgages taken out during the boom years. Many borrowers will be unable to afford the higher payments. The anticipated result is another disastrous wave of foreclosures.

The mortgage debt overhang was the result of financial deregulation and securitization, which created a massive housing bubble. When it inevitably burst, housing prices plummeted, but mortgages did not. The resources of the once-great middle class were then diverted from spending on consumer goods to trying to stay afloat in this sea of debt. Without demand, stores closed their doors and workers got laid off, in a vicious downward spiral.

The glut of underwater mortgages needs to be written down to match underlying assets, not just to help homeowners but to revive the economy. However, most of them cannot be written down, because they have been securitized (sold off to investors) in complicated trust arrangements that legally forbid renegotiation, even if all the parties could be found and brought to agreement.

Reviving the HOLC

The parties themselves cannot renegotiate, but the Fed could. The Fed is already voraciously buying up mortgage-backed securities. What it is not doing but could is to target underwater mortgages and renegotiate them after purchase, along the lines of the Home Owners' Loan Corporation (HOLC) created during the New Deal.

The HOLC was a government-sponsored corporation created in 1933 to revive the moribund housing market by refinancing home mortgages that were in default. To fund this rescue mission without burdening the taxpayers, the HOLC issued bonds that were sold on the open market. Although 20% of the mortgages it bought eventually defaulted, the rest were repaid, allowing the HOLC not only to rescue the home mortgage market but to turn a small profit for the government.

In 2012, Senator Jeff Merkley of Oregon proposed the large-scale refinancing of underwater mortgages using an arrangement similar to the HOLC's. Bonds would be issued on the private bond market, capitalizing on today's very low US government cost of funds; then underwater mortgages would be bought with the proceeds.

For the bonds to be appealing to investors, however, they would need to be at 2-3% interest, the going rate for long-term federal bonds. This would leave little cushion to cover defaults and little reduction in rates for homeowners.

The Fed, on the other hand, would not have these limitations. If it were to purchase the underwater mortgages with QE, its cost of funds would be zero; and so would the risk of loss, since QE is generated with computer keys.

Finance attorney Bruce Cahan has another idea. If the Fed is not inclined to renegotiate mortgages itself, it can provide very-low-interest seed money to capitalize state-owned banks, on the model of the Bank of North Dakota. These publicly-owned banks could then buy up mortgage pools secured by in-state real estate at a discount off the face amount outstanding, and refinance the mortgages at today's low long-term interest rates.

The Eminent Domain Alternative

The Fed has the power (particularly if given a mandate from Congress), but so far it has not shown the will. Some cities and counties are therefore taking matters into their own hands.

Attracting growing interest is Professor Bob Hockett's eminent domain plan, called a "Local Principal Reduction program." As described by the Home Defenders League:

> The city works with private investors to acquire a set of the worst, hardest to fix underwater mortgages (especially "Private Label Securities" of PLS loans) and refinances them to restore home equity. If banks refuse to cooperate, cities may use their legal authority of eminent domain to buy the bad mortgages at fair market value and then reset them to current value.

This plan was initially pursued by San Bernardino County, California. Then Richmond, California, took up the charge, led by its bold Green Party mayor Gayle McLaughlin. Now some councilmen have gotten on the bandwagon in New York City, a much larger turf that encroaches directly on Wall Street's. At a news conference on June 25th, New York City Council members and housing advocacy groups called on the mayor to use the eminent domain option to help underwater homeowners in distressed areas.

The latest breaking news on this front involves the City of San Francisco, which will be voting on a resolution involving eminent domain on July 8th. The resolution states in part:

> That it is the intention of the Board of Supervisors to explore joining with the City of Richmond in the formation of a Joint Powers Authority for the purpose of implementing Local Principal Reduction and potentially other housing preservation strategies . . . .

The MERS Trump Card

If the eminent domain plan fails, there is another way local governments might acquire troubled mortgages that need to be renegotiated. Seventy percent of all mortgages are now held in the name of a computer database called MERS (Mortgage Electronic Registration Systems). Many courts have held that MERS breaks the chain of title to real property. Other courts have gone the other way, but they were usually dealing with cases brought by homeowners who were held not to have standing to bring the claim. Counties, on the other hand, have been directly injured by MERS and do have standing to sue, since the title-obscuring database has bilked them ofbillions of dollars in recording fees.

In a stunning defeat for MERS, on June 30, 2014, the US District Court for the Eastern District of Pennsylvania granted a declaratory judgment in favor of County Recorder Nancy J. Becker, in which MERS was required to come up with all the transfer records related to its putative Pennsylvania properties. The judgment stated:

> Defendants are declared to be obligated to create and record written documents memorializing the transfers of debt/promissory notes which are secured by real estate mortgages in the Commonwealth of Pennsylvania for all such debt transfers past, present and future in the Office for the Recording of Deeds in the County where such property is situate.
>
> IT IS STILL FURTHER ORDERED AND DECLARED that inasmuch as such debt/mortgage note transfers are conveyances within the meaning of Pennsylvania law, the failure to so document and record is violative of the

Pennsylvania Recording Statute(s).

Memorializing all transfers past, present and future, probably cannot be done at this late date – at least not legitimately. The inevitable result will be fatal breaks in the chain of title to Pennsylvania real property. Where title cannot be proved, the property escheats (reverts) to the state by law.

Only 29% of US homes are now owned free and clear, a record low. Of the remaining 71%, 70% are securitized through MERS. That means that class-action lawsuits by county recorders could potentially establish that title is defective to 50% of US homes (70% of 71%).

If banks, investors and federal officials want to avoid this sort of display of local power, they might think twice about turning down reasonable plans for solving the underwater mortgage crisis of the sort proposed by Senator Merkley, Professor Hockett and Attorney Cahan.

Ellen Brown is an attorney, founder of the Public Banking Institute and the author of twelve books, including the best-selling Web of Debt. Her latest book, The Public Bank Solution, explores successful public banking models historically and globally.

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