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RESEARCH

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Mandatory Mortgage Modifications and the U.S. Constitution

Highlights

- The Bush administration's failure to articulate or enact a comprehensive solution to the enormous debt overhang homeowners face is rooted not only in free-market ideology, but also in fundamental constitutional law and case history dating back to the Great Depression.

- The federal government, through its control of Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the FDIC, already controls and–together with the taxpayer–is fully exposed to the risk of loss on over 60% of the +$11 trillion of residential mortgage loans outstanding. The government must step up its modification program to a level far more aggressive than that suggested by the Federal Housing Finance Agency this week. We like the ideas espoused by Sheila Bair of the FDIC with respect to the treatment of government controlled mortgages.

- Notwithstanding laudable efforts on the part of Ms. Bair and some others, the fact remains that the greatest concentration of troubled loans are trapped in "private-label" securitizations. Over $2 trillion of the most toxic subprime ARMs, Alt-A, Option ARMs and prime/subprime jumbo loans, are controlled by bond indentures administered by trustees and servicers with a strong disincentive to engage in widespread mortgage modifications or forgiveness.

- The settlement of loans in private securitizations, the source of over 60% of all current loan delinquencies and defaults, is critical to the stabilization of the housing market and the resolution of the present crisis. Yet government efforts to "jaw-bone" securitization trustees and servicers into taking actions that are not in their economic or legal interests have failed to date and will continue to fail.

- In our opinion, a loan resolution program that mortgage loan holders (securitization trusts and otherwise) are mandated by law to accept, is the only productive remedy. Such a solution, however, would face significant obstacles under constitutional law and the extensive case law precedent. Nevertheless, it is possible to craft a solution that is narrowly tailored to be sustainable within limitations of constitutional property and contract protections.

- If we fail to be proactive in the mortgage crisis and address the most toxic mortgages, the emergency will drag out to a point where, combined with a severe recession, housing prices will decline well below the level at which they should otherwise find stability. With a mandated solution grounded on constitutionally defensible principles, and a more thorough understanding of the issues by those within government, resolution of this crisis can finally get under way in earnest. Such a solution is described in this report.

Overview

The Bush administration's failure to articulate or enact a comprehensive solution to the enormous debt overhang homeowners face is rooted not only in free-market ideology, but also fundamental constitutional law and case history dating back to the Great Depression. Supreme Court decisions on government-mandated mortgage settlement or modification programs during the 1930s make it enormously complicated to legislate a truly complete solution to the mortgage debt debacle—complicated, but not impossible.

Not only does our present dilemma face a legitimate constitutional obstacle to the ex-post facto changing of laws affecting the making and performance of private contracts such as mortgages (a key pillar in maintaining the right to own and preserve private property), but the Constitution also limits the federal government's power to take private property–including the substantial impairment of contract interests–without fair and equitable compensation.

These original, widely interpreted and accepted underpinnings of our legal and economic system are now confronted by widely misunderstood and, as yet, under-interpreted forms of financial engineering, none of which could have been contemplated in the 1930s. The unique constitutional expertise necessary to parse through what will and won't work in possible legislative cures is not generally part of mortgage securitization experts' repertoire. But thinking "outside the box" in both disciplines is critical to finding a workable solution to our crisis.

Underlying Situation

Here are the unfortunate facts: While the federal government, through the de facto near-nationalization of the GSEs Fannie Mae and Freddie Mac, and the Federal Home Loan Banks (FHLBs), has effective dominion and control over nearly 60% of the $11+ trillion of outstanding U.S. mortgages, most are "prime" mortgages and therefore not directly in the eye of the present storm (although plenty of mortgages previously considered prime are threatened by plunging housing prices). Subprime mortgages of all varieties are overwhelmingly held in so-called private-label securitization pools or by major banking institutions that got stuck with whole loans in their securitization pipelines (and problem loans they had bought out of securitizations to avoid costly cash flow triggers) when the music stopped in the subprime lending business. Another group of troubled loans completely in private hands are the "jumbo" mortgages that exceeded, in size, the GSEs' qualifying guidelines—even though they may have been regarded as prime—and are in private hands, securitized or otherwise. (Think of these as the McMansion loans that were particularly vulnerable to the housing bubble's massive price inflation and borrower stretching). Finally, there are subprime and prime loans directly under the control of the government via the FDIC, taken over from banks the agency has seized, whose numbers are relatively small but growing.

While the government is, practically speaking, the largest U.S. mortgage lender (and today involved in more than 80% of all new loans), its ability to modify payments and reduce ultimate principal obligations on the sizable majority of the most severely troubled mortgages is nil as a matter of law to date. And so, the Federal Housing Finance Administration (FHFA) and other executive branches, through and including the FHFA's announcement this week, have resorted to “jawboning” the portion of the mortgage industry over which they have no effective control. This moral suasion has had industry “cooperation” through special-sounding, congressionally appealing programs like Hope for Homeowners and HOPE NOW. As well-meaning as such programs are, the industry involvement therein has generally amounted to making sure the government does not unduly interfere with the private prerogatives and contract rights of mortgage banks and servicers. The programs themselves haven’t had—and have no ability to generate—a meaningful impact on the crisis.

One bright light, in terms of government action, has been the wise efforts of the FDIC, under indefatigable Chairperson Sheila Bair, to aggressively modify loans under its direct control. While Ms. Bair’s program has been far more effective than anything the government has pursued to date, it is necessarily limited to mortgages under the government’s control. And while she has been arguing to expand her program to privately held loans, the best the FDIC has been able to come up with, according to press reports, is the suggestion that the government guarantee lenders, in whole or in part, against such losses. One doesn’t need to be a free-market ideologue to see this would mean bailing out all the folks who invested in the foolish loans contained in the subprime and jumbo securitization pools, among others. On that score, in his press conference this week, Treasury Secretary Paulson issued a political “thanks, but no thanks” to Ms. Bair.

Addressing the Problem: Government Controlled Mortgages vs. Privately Held Mortgages

The government can do much more than FHFA suggested this week to restructure loans under its control in the GSEs (the remaining 20% shareholder interest in Fannie and Freddie must also be immediately nationalized to eliminate legal challenges from outside shareholders), or via the FHLBs and FDIC. The feds must be willing to take the hit on defaulted and/or underwater loans, either restructuring them directly, or preferably monetizing them at fair prices to parties that will acquire them, reset payments to affordable levels *and* offer principal reduction over time in exchange for borrower performance (full disclosure: our firm is in that business). This must occur with deliberate haste as foreclosures mount and home prices continue to fall. The government needs to insist that regulated banking institutions (in exchange for the capital infusions they will continue to require under TARP) do likewise, as the sale for cash of $1 of already marked-down, non-performing assets will be $1 less the government needs to inject into banks.

The problem of the private-label securitizations holding more than $2 trillion of our nation’s most troubled loans, and other loans in private hands, will not be addressed by any of the foregoing—but nevertheless must be tackled with equal vigor. The law, tested on similar issues during the Great Depression, simply does not permit fiat legislation mandating the same type of modifications described above. And the unique attributes of securitizations make it extremely unlikely that anything but a mandated solution will have any effect.

Residential mortgage-backed securitization pools are groups of mortgage loans that have been bundled to issue debt interests in multiple classes, reflecting varying seniority and levels of payment risk. In making reference to securitizations, the business media often refer to securitized mortgages as “sliced and diced mortgages.” In fact, this is a bit of misnomer. The mortgages in securitized pools are happily whole—floating in the pool attended by a trustee, on behalf of the securities' holders, and a mortgage loan servicer, retained by the trustee to collect payments and deal with defaults and delinquencies. It is the regular cash flow from the mortgage payments (and mortgage maturity, prepayment and foreclosure proceeds) that is sliced, diced and paid to the various classes of securities in accordance with a fixed priority.

Now, here's the rub: Any really appropriate action securitization trustees and servicers take to modify loan payments or, heaven forbid, actually write down mortgages' principal to the market values of the homes securing them, will result in one or more classes of the securities being severely impaired or entirely wiped out. Because the governing documents of securitizations never contemplated what would happen in an environment where home prices fall dramatically, there is no road map servicers can rely on to prove they "did the right thing," and any major moves could expose them to massive lawsuits alleging they acted too hastily or without prudence. As a result, servicers and the trustees to whom they report have a profound disincentive to act, even with the government flapping its gums about the need to do so.

A Targeted and Constitutionally Sustainable Solution

With our decades-long experience in structured finance, we have developed a mortgage crisis plan—The Freedom Recovery Plan (www.westwoodcapital.com/freedomrecovery)—that has received some attention in the media. The plan was developed with an eye toward implementing a program that would be mandatory for lenders and servicers, granting them full performance on the mortgages they hold in the form of structured "deed-in-lieu" settlements between electing borrowers (owner occupants only, no investor properties) and mortgagees. The plan incorporates a lease-back of the surrendered home to the previous owner for a period of four to six years, and a right to reacquire the home at fair market value once the present crisis subsides and the former homeowner has an opportunity to regain financial health by the end of the lease term. The plan eliminates the onerous costs and disruptions of adversarial foreclosure and creates an after-market for homes subject to what we have termed "Recovery Leases."

Of critical importance, the plan we have proposed is designed to address what we view as the most controversial issue of this crisis: the need to *mandate* changes to distressed loans among the more than $2 trillion of highly toxic mortgages currently beyond the government's reach (as well, of course, as those within it). We believe, especially after considering the Depression-era precedents, this plan is defensible from a constitutional standpoint, as the only impairment of mortgagees' rights being suggested under the plan is the requirement to lease the repossessed home for a relatively short period, for which the mortgagee is being fairly compensated on a fair market analysis that we believe would withstand claims of a government "taking." It is also our belief that the plan is narrowly tailored to address the current public need. The body of law regarding rent stabilization and control regulations also provides useful precedent on government-imposed use limitations on existing housing.

To date, we have seen no other legally sustainable plans effectively mandating the modification or settlement of troubled loans held by private-label mortgage securitizations, in a manner that will keep people in their homes. Some proposals we have seen may result in marginal relief, but harbor either potential constitutional pitfalls or largely involve bailing out investors in severely impaired mortgages so as to enable the feds to get control of such loans.

Conclusion

One fact is very clear: If we fail to be proactive in the mortgage crisis and address the most toxic mortgages trapped in trusts and elsewhere, the emergency will drag out to a point where, combined with a severe recession, housing prices will decline well below the level at which they should otherwise find stability. With a mandated solution grounded on constitutionally defensible principles, and a more thorough understanding of the issues by those within government (although we've had very useful conversations recently with some very committed people in Treasury and Congress), resolution of this crisis can finally get under way in earnest. Our structured debt industry used legal and financial principles (the latter, faulty) to engineer this crisis, with the view that nothing is impossible. The industry was dead wrong in its economic assumptions—but nothing is impossible with careful structural consideration.

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