

Ending Foreclosures With Local Solutions



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Wall Street abuses! Inaction in Washington! Regardless of where one points the finger, the foreclosure crisis continues to devastate the American economy.

Community banks are particularly hard hit, through no fault of their own, and many have failed, seized by regulators or snatched up by larger banks seemingly immune to regulatory heavy handedness. Collapsing real estate markets have a domino effect on institutions that are dependent on healthy real estate values, in particular local governments that rely on property taxes.

The problem is that the players who might have a solution to the crisis are pressured in ways that exacerbate it. For example, community banks would be penalized by the FDIC and other regulators if they tried to help homeowners by renegotiating their loan payment amounts, providing them payment holidays or simply writing down the value of the loans. The federal government would have to initiate a massive new program to cover the costs to the banks that would produce, or require regulators to radically alter their rules to allow banks to take such actions without a negative impact on their own status. Neither is politically feasible. And Wall Street banks have no motivation to step in and solve the crisis that they helped to create.

But there is a way out. Local governments, primarily at the county level, can exercise certain of their legal rights, including the right of eminent domain.¹ And they can go much further if they also make creative use of existing banking laws.

COUNTIES & FORECLOSURE

Most of the legal procedures associated with foreclosures occur at the county level, including legal filings, court hearings and the too familiar process of sheriffs evicting homeowners after foreclosure. This allows counties to begin implementing a solution in three simple steps:

Step 1: Counties can declare a moratorium on foreclosures on the grounds that they are economically harmful to all residents of the county, not just individual homeowners and mortgage holders). The decline in overall property values following foreclosures impacts the revenue of the county and other government entities that depend on property tax revenues. Reducing or stopping foreclosures is clearly in the public interest and is the first step in solving the problem locally.

Step 2: The county can order its sheriffs not to evict any property owner as a result of already instituted foreclosure proceedings or other parties that have moved into foreclosed homes as part of the Occupy Our Homes² movement and other similar activities. That would prevent homeowners being thrown out on the street and provide homes for those already evicted.

Through the exercise of eminent domain and creative use of existing banking laws, local governments can solve the foreclosure problem.

Step 3: The county can begin working with homeowners who are under threat of foreclosure to distinguish which homeowners have mortgages primarily with local institutions versus those that have been re-sold and currently held by MERS (Mortgage Electronic Registration Systems, Inc.) or other non-local institutions. MERS is a private mortgage registry that Fannie Mae and Freddie Mac formed along with major banks to bypass public registration of deeds and facilitate the creation of mortgage-backed securities. MERS holds about half of the mortgages in the country.³

THE PROBLEM WITH MERS

MERS was created to simplify the bundling of large numbers of individual mortgages into other financial instruments, which resulted in the breakdown of the normal process of title transfer. One reason for that was a desire by the owners of MERS to avoid title transfer costs and thus increase their profits on securitizing those mortgages. The result is that many homeowners are paying on mortgages for which no clearly defined mortgage holder can be identified.

The majority of state attorneys general are in battles with Fannie and Freddie over their unresponsiveness to homeowners' need to reduce their debt⁴ and the imposition of foreclosures even when proper title cannot be presented.⁵ Yet in order to perfect a foreclosure claim, a mortgage holder is supposed to have clear title to the property, giving them the right to seize the property for non-performance on the part of the mortgagor (homeowner).

Where clear title cannot be evidenced, the law should be on the side of the homeowner. But courts, banks and law enforcement have often run roughshod over homeowners who, without the financial resources to fight foreclosure proceedings, are often powerless to stop the juggernaut. If the purported mortgage holder cannot prove clear title, then the law is clear that the homeowner should be able to retain possession and control of their property. Yet many homeowners have been foreclosed improperly and forced out of their homes.

Some homeowners have successfully prevailed in court by demanding that the foreclosing entity prove title, which in many cases they could not. Of course,

such a legal battle requires financial resources that are usually missing because the homeowner is already in financial difficulties, causing the foreclosure proceedings in the first place.

COUNTIES, MERS & EMINENT DOMAIN

How can a county use that credit generating ability? This is where counties can come to the rescue. If the financial institution (typically downstream from the originating bank and rarely a community bank) cannot demonstrate clear title, the county can invoke its power of eminent domain to resolve the issue. Eminent domain allows a government entity to seize not just physical property but intangible property such as contract rights, patents, trade secrets and copyrights, provided that doing so is in the public interest and the owner is compensated at fair market value.

Counties simply need to provide adequate public notice that the property is subject to eminent domain seizure. If the lender cannot provide proof of title by the end of the notice period, the county can proceed with the seizure uncontested. Since there is no identifiable party to compensate, this procedure costs the county next to nothing.

Regardless of the cloud over the title prior to the seizure, clear title is once again established afterward. We have a long history of counties re-establishing clear title, as in cases where property is seized (e.g., for failure to pay taxes) and sold in what are often called "sheriff's sales." The title industry considers such sales to wipe out all previous title history, and any future title searches only go back to that date.

As the title cost the county essentially nothing, it can negotiate terms with the homeowner that will re-define what portion of the property the homeowner is allowed to retain and also allow the homeowner to remain in the home. That could include a temporary moratorium on any payments pending improvement on the homeowner's financial condition. At a very minimum the county can then rent the home to the (former) homeowner.⁶

The net result of this process is:

1. Foreclosures and their negative ripple effect on the local economy are reduced.
2. More homeowners remain in their homes, helping to preserve neighborhoods.

3. The county receives new revenues.

THE MORAL ARGUMENT

In addition to the economic benefits of stopping foreclosures, this process addresses the fact that the MERS system was designed to skirt legal procedures in pursuit of profit. The foreclosure crisis stands at the very center of our economic woes, and since the federal government appears incapable or unwilling to address this problem, this solution lies with local communities.

The nature of free market capitalism is that you risk losing your investment. If, like the owners of MERS, you do so because you played fast and loose with the rules, then taxpayers especially should not be required to bail you out, as MERS owners might demand if their system starts to significantly unravel.

LEGITIMATE MORTGAGES

What can the county do when the titleholder is a financial institution, like a community bank, that normally does not re-sell its mortgages?

The county can still exercise eminent domain and seize the property, paying fair market price. Actually, were the bank to be paid the current appraised value for the property, it would in most cases come out financially ahead of what it could realize from a foreclosure sale.

How does the county finance the eminent domain purchase of a property at fair market value? Currently, that means borrowing the funds from other institutions and repaying them out of tax revenues and/or the revenues realized from payments by the homeowners.

One could argue that the revenue from all of the properties seized (both the MERS properties and those bought for full market value) should be adequate to service the debt. But the county has another tool that allows it to go far beyond financing seized properties and into facilitating the larger credit needs of the county and its residents.

PUBLIC VS. PRIVATE BANKS

The solution begins with banking and, in particular, “public banking.”⁷ Rather than being owned by private investors, public banks are owned directly or

indirectly by the public sector (the federal government, states, counties, cities and other administrative districts). Examples can be found around the world, but with the exception of the Bank of North Dakota (BND,⁸ a DBA⁹ of the state of North Dakota) and a few non-profit-owned banks, banks in the United States are owned by private investors.

Nonetheless, BND can serve as a model for what is possible in other jurisdictions. North Dakota has the healthiest economy of any state, with a low 3.5% unemployment, no credit crisis and the lowest default rate on loans. It is also one of only two solvent states in the country. And even though oil is often cited as its secret to success, it is not. Profits from BND are the largest revenue source for North Dakota with oil-related revenues coming in second.¹⁰

In contrast to what many might assume, BND does not compete with private banks but instead serves as their mini-Fed, partnering with community banks in a manner that proves to be very profitable for them. The state actually has more local banks per capita than any other and has had no bank failures in more than a dozen years!

The BND success story is catching on. Several states are exploring variations on the North Dakota model. For example, the California legislature recently passed a bill¹¹ to study the feasibility of establishing a state-owned bank. Even cities are looking to get into the act: A recent mayoral candidate in San Francisco advocated a city-owned bank.¹²

We can see similar BND stories in other countries. In May 2010, *The Economist*¹³ noted that the strong and stable publicly owned banks of India, China and Brazil helped those countries weather the banking crisis. And Germany, with one of the healthiest economies in Europe, has a large number of public banks,^{14,15} accounting for about 40% of the country’s banking assets. Those public banks are for the most part found at the local level and their primary focus is on supporting small business and local economies. Germany has one of the strongest small business communities in the world.

So how can this public banking concept be used to help solve the foreclosure crisis?

CITY & COUNTY-OWNED BANKS

Counties and medium-to-large sized cities can take direct control of their local foreclosure problem and resolve it using banking laws along with eminent domain. Let's use a county as an example.

The county applies to its state's banking regulatory body for a state bank charter¹⁶ (all states define the requirements for charters and oversee compliance.) Once a charter is granted, a bank can commence normal banking activities that conform to internationally accepted processes and procedures. However, all banks are not alike in who they serve and using the BND model, we would advocate that they not offer retail banking services to the general public (personal checking and savings accounts, car loans etc.), but rather serve the community in a wholesale banking role like BND.

How will that help solve the foreclosure problem? By taking advantage of how banks work and their unique role in injecting money into the economy.

One fundamental banking activity is the ability to create credit (money). As explained on the website of the Bank of Dallas, one of the twelve regional Federal Reserve banks, under the section entitled How Banks Create Money "Banks actually create money when they lend it." Here's how that works:

When a bank creates credit for a borrower, it does not reach into a pool of existing funds but rather creates that credit simply with an accounting entry.¹⁷ (For example, if my bank grants me a \$20,000 car loan, it does so by entering a liability on the bank's balance sheet to give me \$20,000, offset by an entry on the asset side of its balance sheet represented by the loan document I signed. It doesn't have to get that money from depositors or anyone else, but creates it out of thin air!)

The only constraint on how much credit money banks can create is based on a long-standing convention that limits the amount to a multiple of the bank's assets. That varies by jurisdiction (i.e., conditions set by local regulators) and the prevailing economic climate, but averages around 10 times, i.e., for every \$1 in assets owned by the bank, it is allowed to create \$10 in loans. Thus, a new bank capitalized

by \$10 million dollars is able to create approximately \$100 million in loan money for borrowers!

So if our example bank is established as a DBA of the county, the entire balance sheet of the county is essentially the starting balance sheet of the county bank. If the county owns just a \$100 million in net assets (a small county by most standards) that county bank would have the credit generating capability of up to \$1 billion, that is, it can create \$1 billion out of thin air, just like any other bank, that it can make available to its own citizens simply because it and they own those assets!

And they don't have to turn to Wall Street, Washington or anyone else to make that money available to their community.

PUBLIC BANKS & FORECLOSURES

How can a county use that credit-creating ability to solve its foreclosure problem? It takes just two steps:

1. The county issues a moratorium on all foreclosures, requiring instead that all mortgage holders deal with the county bank instead of instituting foreclosure procedures against property owners.

2. It buys distressed real estate loans from the existing lenders, just as the Federal Reserve did by buying toxic assets from the Wall Street banks. The county bank acquires those loans by creating a credit account for the current mortgage holder in the amount of the fair market purchase price for each loan/property. This now puts the distressed mortgage in the hands of the county.

This benefits everyone: the county, the homeowner and the mortgage holder - especially if it is a local bank.

GOOD FOR THE COUNTY

For the county, this solution has multiple positives. From a broader perspective, a moratorium on all foreclosures will go a long way toward stopping the collapse in property values and hence tax revenues. Most taxed-based government entities have been devastated by the drop in property values, and this solution would not only prevent further revenue declines but actually increase revenues.

By taking the steps outlined, a county can now own additional revenue generating assets, without having to fork over any up-front cash to acquire them. The current mortgagor (home owner) may not be able to pay the full amount of their current mortgage obligation, but many are in a position to pay a portion of that obligation.

Commercial banks are not in a position to accept lowered payments, but a county bank would be in a totally different position. Any revenue that the county bank collects is essentially new money that would not otherwise be going into county coffers. Thus the county is incentivized to negotiate with property owners to pay any amount they can afford. The county is also disincentivized to foreclose, given the revenues it would forego, plus the drop in overall property values a foreclosure precipitates.

GOOD FOR THE HOMEOWNER

Property owners facing foreclosures would get a reprieve. A county-mandated foreclosure moratorium would immediately relieve many mortgagors from the fear of losing their homes or declaring bankruptcy. They could negotiate terms with the county bank that would allow them to remain in their homes while they work through their financial difficulties.

GOOD FOR THE LOCAL BANK

The terms of the purchase would require the selling bank to leave the mortgage purchase proceeds on the books of the county bank (similar to a reserve deposit with the Fed) until the county bank releases those funds (which it may do only when the property is sold or based on some other conditions stipulated by the county bank). For the selling bank, this has two major benefits, both of which improve its health significantly.

First, by selling the loan to the county bank for the fair market value of the property, the bank gets rid of a bad loan without having to show the loss on its books that it would be forced to take on the sale of a property post foreclosure, a plus for regulators like the FDIC when evaluating and rating a bank's loan portfolio.

Second, no money has actually changed hands

up front. The selling bank just reports the proceeds from the sale of the mortgage as a deposit with another bank. That makes the selling bank's balance sheet even stronger (deposits in other banks like the Fed are viewed by the regulators as equivalent to cash assets).

The result is that a previously unhealthy community bank can return to fiscal health and be in a much better position to turn on its lending spigot to address other local credit needs.

HOW CONGRESS CAN HELP

Because it builds on long-established rules, this public banking solution does not require any new laws. However, there are two areas where existing federal rules could potentially interfere:

1. The Federal Deposit Insurance Corporation (FDIC).¹⁸ Born out of the mass bank failures of the 1930s when many depositors lost all their money, FDIC was formed to protect the public by insuring depositors' funds up to a certain limit. That limit was recently raised to \$250,000 and is intended primarily to protect individual, retail depositors. Larger depositors, wealthy individuals, businesses, government entities and others are left to protect themselves, as the government is primarily concerned with protecting the "little guy."

As part of its role in guaranteeing such deposits, FDIC also serves as a primary regulator over its participating banks, and is empowered to seize such banks if they fail to follow FDIC guidelines, including the quality of their loan portfolio and their basic financial condition. And although participation in the FDIC insurance program was originally voluntary for banks, current federal law requires that all new banks join the FDIC program and be subject to its provisions.

The problem with that regulation with respect to publicly owned banks is that public banks should not be in the retail banking business and taking deposits from the general public. Therefore the primary party that FDIC is designed to protect is not even part of the equation.

Furthermore, although it makes sense for the FDIC to have the authority to seize a private bank

and all its assets, seizing a publicly owned bank, especially if it is structured as a DBA of the governmental body (in our example the county itself), would mean that FDIC could seize all the county's assets. That clearly is inappropriate. Any tax-based government entity is always capable of taxing its way out of its financial problems and bankruptcy (for example) is an extremely rare event for any government entity in the United States.

The simple solution is to have Congress exempt all publicly owned banks from participation in the FDIC insurance program.

2. The Bank Holding Company Act.¹⁹ A bank holding company is a company (other than individuals) that controls (owns) one or more banks, but does not necessarily engage in banking itself.²⁰

For example, if Corporation A owns Corporation B and Corporation B is a bank, then Corporation A would be considered a bank holding company and be subject to the Bank Holding Company Act. If our hypothetical county formed a separate corporation to be the entity that is its county bank (rather than as a DBA of the county), then by definition the county would be a bank holding company. That would have its own consequences similar to the FDIC problem.²¹ Here's why.

One of the key provisions of the Bank Holding Company Act granted regulatory jurisdiction over bank holding companies to the Federal Reserve.²² This not only means that the county would be subject to inappropriate regulatory oversight (it would not engage in the kinds of activities or structures that the act was intended to oversee), the regulator is not even a government entity, but an aggregation of several private corporations.

The Federal Reserve is composed of one central bank (often called "The Fed") that is owned and controlled by twelve regional federal reserve banks that are in fact private corporations. As noted by the Ninth Circuit Court of Appeals, "The Reserve Banks are not federal instrumentalities for purposes of the FTCA [the Federal Tort Claims Act], but are independent, privately owned and locally controlled corporations."²³

That would mean that a group of private corporations (themselves controlled primarily by the big

banks and other corporate interests) would have regulatory oversight over a government. The inevitable battles that could produce would be avoided by Congress establishing an exemption from the Bank Holding Company Act for public banks. That, coupled with the FDIC exemption, would clear the way for states, counties and cities to set up their own banks and help their communities in ways not possible under current conditions.

OTHER BENEFITS OF A COUNTY BANK

The Bank of North Dakota provides examples of ways in which a public bank can support the credit needs of its community in a manner that nurtures and supports the existing local banking community and its constituents.

Those could include loan guarantees to banks for targeted lending to small businesses or for such things as renewable energy projects. We recommend that any government body that intends to establish its own bank consider establishing an advisory group that represents all the major interests in the community (businesses, non-profits, other government entities, the general public, etc.) that would evaluate what the county bank should do to help the community realize economic and other goals. Such a group could also establish guidelines that ensure both safe banking practices and prevent inappropriate allocation of bank resources to private parties through cronyism or political influence.

A county bank would be leveraging the sum total of the assets owned by the county and thus the public, who have paid for those assets through many years of investment via their tax dollars. Public banking allows citizens and their government to monetize those assets without having to sell them off, especially for pennies on the dollar in fire sales as some jurisdictions have done. That is because of the unique characteristics of banking laws that allow a bank (and thus the county) to create credit money by virtue of just owning assets, without having to liquidate those assets in the process.

START NOW!


What could your community do if it had the ability to create all the credit it could possibly use to rebuild its economy and get back on the road to

economic health? You don't have to wait for Washington or Wall Street to come to the rescue. You can start now! The National Commonwealth Group, Inc., a 501(c)(3) non-profit corporation, will be facilitating networking between groups interested in setting up their own public banks, and can help provide guidance to parties interested in exploring this solution.

At the very least county administrators should be petitioned to place a moratorium on local foreclosures and exercise the eminent domain seizure of those foreclosure candidate properties for which no clear titleholder can be established. That will require no new systems at the county level and will go a long way to ending the devastation of foreclosure.

HOW TO REACH US

 www.nationalcommonwealthgroup.org

 650 641 1246

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