The Feudal Mistake

In recent years, mortgages have been carved up into so many pieces that the re-working of mortgages — and the saving of homes from foreclosure — is not happening even when there are responsible homeowners who are willing and able to make reasonable payments. History provides a clear lesson as to what Congress should do about this mess. In feudal England, trade in land was burdened by a legal system that recognized a myriad of current and future interests that could lay claim to any parcel. English and American judges created and used legal doctrines to undo the excessive fragmentation of ownership interests in land. Right now, Congress should take that legal history as inspiration and enact reforms that would allow the re-working of mortgages without the consent of all the owners of the securities that are in some way “backed” by or “derived” from troubled mortgages.

From the Seventeenth Century onward, English and American law encouraged the holding of land in what is called a “fee simple” — a kind of ownership where all the interests in the land are held by a single entity that can make economically rational land use decisions (including whether to sell the land to someone else who values it more). The judges promoted unified ownership of land through aggressive means, in some cases plainly rewriting wills and contracts to remove contingent or uncertain claims on land.

The recent developments in the mortgage-backed securities and derivatives markets prove the wisdom of the English and American judges. The structure for mortgage-backed securities that has been used in recent years makes re-working of mortgages a near impossibility. Some mortgage-backed securities holders benefit more if the mortgages do not go into default and the properties do not enter foreclosure, while others benefit more if the mortgages do go into default and the properties do enter into foreclosure. Because many mortgages are pooled in each security, hundreds or even thousands of investors may gain a tiny advantage from any single mortgage not going into default or instead going into default. Under these circumstances, it is not feasible to obtain the consent for a re-working of a mortgage from all the investors who may have some kind of financial stake.
Congress should follow the path of post-feudal property law by eliminating any requirement that all investors in a mortgage consent to the re-working of the mortgage. Instead, government-appointed trustees should be authorized to employ the same criteria for re-working that a community bank traditionally would use when it holds a 100% stake in the mortgage. One of the criticisms of this plan to facilitate the re-working of mortgages has been that doing so may infringe upon the “property rights” of some of the investors in mortgage-backed securities and derivatives. But facilitating rational economic decisions by limiting the effects of fragmentation of ownership interests is consistent with – indeed central to -- the traditions of property law in England and America.

Moreover, since the New Deal, the courts have embraced the general principle that Congress can adopt economic or business regulation that modifies and limits private behavior and privileges so as to advance the public interest without triggering any government obligation to make adversely affected private parties whole.

In any case, the holders of interest in mortgage-backed securities and derivatives will not be wiped out by any government plan that facilitates the reworking of mortgages. The market in these securities is already in such disarray that the institutions that hold them have marked them down to cents on the dollar. Indeed, by placing the decision to rework or foreclose in the hands of agents capable of making economically sensible choices, the great uncertainty about the value of these securities will be eliminated, allowing trading in them to resume. Even more important, by bringing more closure and certainty to a chaotic landscape, government measures to promote mortgage reworking would stabilize the housing market.

Every major financial institution probably would benefit on net from the stabilization of the market in mortgage backed securities as well as the improvement in economic conditions more generally. As the late Justice Brennan explained, regulation that promotes what he called an “average reciprocity of advantage” is precisely what our government is supposed to aim for, and does not implicate the constitutional requirement of just compensation for the government taking of private property.