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Newark's Terrible New Foreclosure Fix Idea: Activists in the city think eminent domain can save their neighborhoods.

The foreclosure crisis hit hardest in cities like Newark, New Jersey. Lenders preyed on low-income areas and made loans to people who had little ability to pay them back. Since 2008, 6,810 homes have been foreclosed in Newark, and citywide, homeowners have lost roughly $1.8 billion in home values, according to a report from the grassroots advocacy group New Jersey Communities United. This wave of vacant properties increased costs for maintenance and public safety by approximately $56 million. Blight increases danger in a city; last July, five residents, four of them children, died in a fire that started in one of Newark's vacant properties. Foreclosures also damage the value of neighboring homes. Another 9,000 Newark residents are "underwater" on their homes, meaning they owe more on their mortgage than what their homes are worth.

The situation has made politicians and activists in Newark desperate, enough to explore a controversial idea: using eminent domain to seize mortgages from the lenders and renegotiate them at the market rate. Eminent domain laws enable municipal, state or federal governments to take property for a public purpose; in this case, the public purpose would be foreclosure prevention and the reduction of potential blight.

While the eminent domain option has been discussed in several cities hit hard by the foreclosure crisis—including Chicago and San Bernardino, California—no city has stepped forward to implement such a scheme. And that's because the way eminent domain has been envisioned, especially by the well-connected company trying to sell many cities on the idea, is legally dubious and incredibly risky for the municipality. Properly structured, eminent domain as a foreclosure prevention tool might work. But there are other ways to stop the proliferation of blight in Newark, none of which involve enriching a third party.

The biggest problem with eminent domain is that mortgages are costly, and city budgets, particularly in communities with foreclosure problems, are strapped. So inevitably, they would have to bring in a private partner to acquire the working capital needed to buy the mortgages before resetting them. This ultimately may save the communities money in the long run, from avoided foreclosure costs and more property tax revenue. But in the near term, they're going to need some money.

So far, only one group has stepped forward as a viable partner, an organization called Mortgage Resolution Partners (MRP), run by several Democratic operatives from California. MRP has attempted to activate their eminent domain plan in several cities around the country, but it's not clear whether the deal makes sense for anybody.

First of all, MRP is only interested in dealing with performing mortgages, where the borrower is current on the loan. These are not the people most in need of help from foreclosure. They actually have some options already: The federal HARP program, which extends refinancing options to underwater borrowers, has proven attractive enough to banks (who make money in fees off the new loan and often lock in rates higher than the going average) to become successful, with over 1 million refinances made. While this doesn’t give underwater borrowers the cheapest possible interest rate, it does often save them hundreds of dollars a month and makes the loans more affordable. It’s borrowers who have missed payments that are most at risk of foreclosure. But MRP doesn’t want to help them.

It’s also questionable whether performing mortgages are condemnable. If borrowers have been paying for years, why does it serve community needs to take those mortgages over? There’s certainly a somewhat higher risk of foreclosure on an underwater mortgage, but the benefit seems to go to the individual borrower rather than the city, which puts the concept in legal jeopardy.

Moreover, under eminent domain, the government entity must offer a “fair value” for the entity it condemns. And there’s a big difference between fair value for a house, and fair value for a mortgage. In this case, if a borrower is dutifully paying their mortgage every month, expectations are high that they will continue paying it. The owner of the mortgage would be unlikely to consider a discounted rate as a fair deal, when the borrower is able to pay full price. Therefore, the only legal way for the government to acquire the mortgage at fair value would be to pay it off in full, a much higher price than the value of the house. MRP, a for-profit company, is obviously more interested in buying the mortgage at a deep discount, taking a cut (reportedly 5.5 percent) when they reset the loan for the borrower and turning a profit. As financial writer Yves Smith, who has criticized this rendering of eminent domain, noted recently, “The mortgages must be stolen.” What’s more, if the borrower were to default on the new loan, MRP would take none of the risk, which would all be borne on the municipality.

There may be ways to structure eminent domain that make sense for both the municipality and investors. But the most-cited proposal on the table has made communities wary once they dig into the details. And this has given the mortgage lending industry time to counterattack. Not only did it threaten to essentially cut off lending to any community that engages in this kind of scheme, it got some back-up, incredibly, from the Federal Housing Finance Agency, the government overseer of mortgage giants Fannie Mae and Freddie Mac. Last August the FHFA sent a notice to the Federal Register that expressed “significant concerns” with eminent domain plans for mortgages, ominously asserting that “action may be necessary” to avoid any risks associated with the program. Perhaps in part because of these threats, the constitutional challenges sure to arise, and the high-risk, low-reward deal from MRP, San Bernardino, the first city to really explore this idea, gave up on it earlier this year.

Cities like Newark have other options to prevent foreclosures and the troubling rise of vacant properties. One of the biggest issues concerns what is known as a bank walkaway. In this scenario, banks pursue foreclosure (typically to collect foreclosure fees) and evict the homeowner, but instead of completing the process, and therefore taking responsibility for maintenance, property taxes and municipal fees, they walk away. Banks often don’t inform the former homeowner or the municipality that they stopped foreclosure, leaving the individual on the hook for any costs, and leaving the municipality confused about whom to hold accountable. This lack of information about abandoned foreclosures violates regulatory guidelines, but banks have accelerated this technique. According to a recent report, over 300,000 vacant homes nationwide are the result of bank walkaways. And one study of Newark showed that almost 43 percent of bank-owned properties in one neighborhood remain vacant.

To combat this, cities could make it cost-prohibitive to foreclose in this fashion. Newark already has a vacant property registration ordinance, which allows for fines of $1,000 a day for failure to register vacant properties or maintain them. New Jersey Communities United argued that the city should fully enforce that ordinance. A better solution would be to ensure that the ordinance gets assessed on the foreclosing bank, whether they abandon the foreclosure or not. A more punitive fee that would stop bank walkaways and force them to put those homes back into circulation could make banks think twice before foreclosing. In Los Angeles, the city attorney has sued several major banks for failing to maintain foreclosed properties. Only changing the financial incentives surrounding bank foreclosures will lead to a change in behavior.

The lack of support at the state and federal level for communities still suffering from the foreclosure crisis has understandably led municipalities searching for answers. But before jumping into eminent domain, cities can use their existing leverage to encourage better treatment of their citizens.

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