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Is the governor's mandatory pre-foreclosure mediation program a good idea?



By Christopher Brown

Recently, Connecticut Gov. M. Jodi Rell and the state legislature's banking committee proposed a bill that would require mediation prior to all home foreclosures in Connecticut. The state currently has a foreclosure mediation program, expanded in 2008, but it is at the borrowers' election. Gov. Rell claims the 2008 expansion has been successful with about 25 percent of borrowers electing mediation and about 70 percent of those who chose mediation being able to stay in their homes.

Can we then say then that mandatory mediation would result in more people avoiding foreclosure and being able to stay in their homes? I think that's a stretch. The truth behind the numbers is that there's a reason only 25 percent of those troubled borrowers are choosing mediation because they are the ones who have the capacity to realistically strike a deal. Those who do not currently choose mediation are, most likely, those who are behind in payments because they have lost their income or have had to spend their savings to support their families. These borrowers cannot make a deal because they have nothing a lender would want. Mandatory mediation will do nothing for these borrowers. As a result, we can expect that those sunny numbers regarding mediation to drop if mediation becomes mandatory.

On the other hand, these mediations may do some good for lenders because they would bring in some regular monthly mortgage payments, albeit smaller ones, that they would otherwise not get while the borrowers stay in their houses.

This benefits the lender more than it might appear at first. Here's how: Lenders generally expect in foreclosure to recover about half of what they are owed on the debt. Of course, this figure likely varies with the geography of the house, but it is probably safe to say that in most cases lenders can expect to recover less through a completed foreclosure than they are owed. As a result, lenders want to consider every possible option for increasing the net amount they recover on any particular loan. Through mediation, the lender will likely increase the net amount they recover by accepting smaller monthly payments temporarily. This is because the bottom has either dropped out of the housing market or will soon. A six, 12- or even 18-month delay is not likely to negatively impact what the lender realizes in completing a foreclosure action. Plus, with the country's focus on stabilizing the housing market, the house might actually be worth more in the future. In the meantime, the lender is getting some payments.

The borrowers, on the other hand, ostensibly get the benefit of remaining in their homes, at least while they are making the adjusted payments. This benefit can be short-

lived. Saving their homes is often borrowers' number one goal. For borrowers, a payment they cannot afford is the number one obstacle to achieving that goal. The natural inclination for these borrowers is to jump at any opportunity to reduce the monthly payment so they can stay in their homes. Some of these borrowers may not be able to make the reduced payments over the long run, but they will choose them because it beats losing their homes right now. The ones that ultimately cannot keep up with the modified payments will eventually end up defaulting and, once again, face foreclosure. They end up out of their homes after giving the lender more money than it otherwise would have collected.

The determining factor of the "success" rate of the proposed mandatory mediation will be the number of borrowers who later end up back in default or foreclosure after a "successful" mediation. Or, to use the technical expression (which is commonly associated with criminal activity) what is the rate of recidivism? Gov. Rell did not mention this statistic in connection with the mandatory mediation bill. In fact, "success" for lenders and borrowers is actually defined by the opposite ends of the recidivist rate. A high recidivist rate means that more borrowers are defaulting again, which increases the likelihood that they will be foreclosed out of their homes. For lenders, a high recidivist rate means that they have minimized their net loss because have received some payments temporarily while still retain the ability to keep the proceeds of the sale of the property when they foreclose.

A low recidivist rate means that more borrowers continue making reduced monthly payments and remain in their homes. For the lenders, this means they don't have to go through the expense and hassle of foreclosure. Of course, the ultimate goal is that such borrowers stabilize their income and eventually start paying their full mortgage payments. If they don't, the lenders are losing out in the long-run because they have to accept the lower payments and cannot force a sale of the property.

So, success truly is relative. Without the recidivist rate, we do not know whether it is the lenders or the borrowers who will benefit in the long-run from the mandatory mediation. We do know that "successful" mediation likely benefits only one group. Mandatory mediation, therefore, increases the benefit to that group at the expense of the other.

In the end, I believe the 70 percent "success rate" is a misleading statistic when it comes to judging the effectiveness of mandatory mediation. As we've seen, it just doesn't tell the whole story.

Attorney Christopher Brown heads the Westport, Conn.-based debtor/credit practice group of Begos Horgan & Brown LLP. He may be reached at (203) 226-9990 or e-mail cgb@begoshorgan.com.