

Economic Brief

SEPTEMBER 2009, EB09-09

Deterring Default: Why Some State Laws Decrease the Probability of Mortgage Foreclosures

By Andra C. Ghent, Marianna Kudlyak,
and Stephen Slivinski

Many states give mortgage lenders strong legal means by which to pursue debt collection in the event of a mortgage default. In those states, probability of default is lower and the forms the default takes are often quite different from a costly conventional foreclosure.

The recent surge in residential foreclosures has spurred interest in the factors that influence whether a borrower will default on his mortgage. The existing academic literature on the subject usually assumes that default is mainly a result of a borrower finding himself with a “negative equity stake” in his home – owing more money on the mortgage than the house is worth. Even borrowers who do not experience a change in their income or mortgage payment might walk away from a home that is “underwater.”

Yet the lender may not be legally able to fully collect the outstanding debt in such cases. Whether a state allows lenders to pursue “recourse” – that is, allows them to seize assets other than the home to recover the debt owed to them – is lost in much of the popular discussion of the current conditions in the mortgage market. Some states do allow lenders to cast a wider net when it comes to recouping their losses from a defaulted mortgage. Other states, such as California and Arizona, for instance, severely restrict the ability of lenders to pursue recourse.

Given this, you should naturally expect that the decision of a borrower to default will be influenced by the ability of the lender to collect on any outstanding mortgage debt not covered by the proceedings from the foreclosure sale. Can the high rate of default seen in some states, then, be at least partly due to the different legal regimes in which these mortgages reside?

In a July 2009 Richmond Fed working paper, two of the authors of the present article, Andra Ghent and Marianna Kudlyak, explored this question.¹ As it turns out, the laws of a particular state matter significantly when it comes to estimating the probability that a borrower will default on his mortgage. Because the possibility of lender recourse – often in the form of a “deficiency judgment” issued by a court – raises the potential cost of default to the debtor, you should expect this to influence the behavior of the borrower.

The analysis suggests that allowing the lender recourse – and the more likely that lender is to exercise that right to recourse – lowers the chances that the borrower will default when he has negative home equity. In other words, the possibility that a lender can recover more than the proceeds from the foreclosure sale can deter default.

Finally, in the cases where default does occur, the form it takes may differ in recourse and non-recourse states.

THE EFFECT OF LENDER RECOURSE ON THE PROBABILITY OF DEFAULT

It is not possible to gauge the effect of lender recourse on the probability of default simply by observing the number of deficiency judgments. On the one hand, pursuing a deficiency judgment for a lender can be a lengthy and expensive process because of costs and time associated with taking the borrower to court. Thus, seeing few deficiency judgments pursued may be an indicator of recourse having no effect on default because lenders simply do not exercise their right of recourse. On the other hand, observing small numbers of deficiency judgments in practice may indicate that recourse has a serious deterrent effect on defaults. In this case, borrowers who have a lot to lose from lender recourse actually choose not to default – and, as a result, never show up in the foreclosure numbers.

To answer the question of how best to explain the data, one needs to compare the default decisions of two borrowers who have identical equity values in their mortgaged properties, loan-to-value ratios, credit scores and other observable traits yet reside in states with different recourse rights for lenders. The analysis described in this *Economic Brief* uses this approach – the approach that Ghent and Kudlyak used in their working paper.

State statutes vary in how much recourse a lender has in the event that a foreclosure sale of a property is not sufficient to cover a borrower's debt. The varying statutes impose different costs on borrowers and lenders and these costs have a bearing on the behavior of both parties. In most states, the lender may obtain a deficiency judgment in court to cover the difference between the balance owed on the mortgage and the fair market value of the home.

A few states explicitly forbid deficiency judgments on most homes. Restrictions on the judgments in other recourse states make it highly impractical and costly for the lender to pursue a court remedy, thereby making it functionally equivalent to a non-recourse state.²

To help gauge how this influences the behavior of a borrower with negative equity in his home, assume that a borrower will ascribe a value to the default option relative to the non-default option. If he thinks the lender is likely to pursue recourse, this lowers the default option value. And, as a result, it also lowers the probability of default given the value of the negative equity in the house.

By this logic, recourse states would tend to see fewer defaults than non-recourse states. And that's just what you see in the data: The probability of default is 20 percent higher in states with no recourse when holding other individual loan characteristics constant.³

However, it's important to note that the effect of recourse on the probability of default differs for properties with different appraisal values. Recourse should have a substantial deterrent effect for properties with higher appraisals. That's because borrowers with more expensive homes are likely to be wealthier and thus have more to lose if the lender pursues a deficiency judgment.

Recourse does more strongly deter default for wealthier borrowers when the appraised value of the property at origination is used as a proxy for the borrower's wealth. For homes appraised at \$300,000 to \$500,000, borrowers in non-recourse states are 59 percent more likely to default than borrowers in recourse states. For homes appraised at \$500,000 to \$750,000, borrowers were twice as likely to default. Mortgages on homes in non-recourse states appraised at \$750,000 to \$1 million were 66 percent more likely to default.

THE EFFECT OF LENDER RECOURSE ON THE TYPE OF DEFAULT

What if a default does occur? Foreclosure isn't the only form that it can take. In fact, lenders typically view litigious foreclosure as a last resort because it can be costly. They will usually try to recover a portion of the principle through other means. Furthermore, lenders have a strong interest in foreclosing quickly on a property as a drawn-out process can lower the value of the property.

For a borrower, there are a few ways to default: a short sale, a voluntary conveyance (the most common form of which is a "deed-in-lieu" resolution), agreeing not to contest a foreclosure, or prolonging the foreclosure process as long as possible. Ghent and Kudlyak find that the form the default takes will be influenced by whether or not the mortgaged property is in a recourse state.

In a short sale, the borrower finds a buyer who is willing to purchase the house for less than the full balance owed on the mortgage. In a deed-in-lieu resolution, the borrower hands over the deed to the property to the lender. Finally, a borrower may simply agree to what is known as a "friendly foreclosure." In that form of default, the borrower chooses not to contest the foreclosure and submits to the court. The main benefit of this option to the lender is that he gets the property back more quickly relative to a contested foreclosure. While a friendly foreclosure might take more time and be more costly than a voluntary conveyance, it is less time-consuming and costly than a contested foreclosure.

Each of these methods is considered more lender-friendly than a conventional foreclosure. As a result, lenders will often agree to forgo the right to a deficiency judgment if the borrower agrees to default through one of these methods than through a lengthy and contested process. Thus, a borrower who has a lot to lose from lender recourse may opt for one of these types of default to keep the lender from pursuing a deficiency judgment. That's what the analysis indicates: When default does occur in the states that allow lenders to pursue broader recourse, it more frequently occurs in one of the lender-friendly ways described above. In fact, recourse laws that favor the lender lower the probability of default through foreclosure by between 9 percent and 11 percent.

CONCLUSION

The sensitivity of the default decision to the legal rules of a particular state suggests that a non-negligible portion of U.S. mortgage defaults is in fact strategic – that is, when the borrower decides to actively walk away from a house that is worth less than the outstanding balance on the mortgage even if he might be able to continue making the payments. This contrasts with the popular view that defaults are driven only by negative shocks to the ability of the borrower to repay his debt, such as job loss or a cut in income.

In fact, as the analysis described in this *Economic Brief* suggests, you do not need to actually observe lenders frequently pursuing deficiency judgments to see the deterrent effects. The fact that lenders have the ability to pursue recourse at all encourages borrowers to think hard about defaulting and, if they do default, what form that default might take. Thus, the ability of lenders to minimize their losses in each state must be considered in any analysis that seeks to discover why some borrowers default and others do not. ■

Andra C. Ghent is an assistant professor of real estate at Baruch College, City University of New York. Marianna Kudlyak is an economist at the Federal Reserve Bank of Richmond. Stephen Slivinski is senior editor of the Richmond Fed's quarterly magazine, *Region Focus*.

ENDNOTES

¹ Ghent, Andra C., and Marianna Kudlyak. "Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States." Federal Reserve Bank of Richmond Working Paper 09-10, July 2009.

² In the analysis, Alaska, Arizona, California, Iowa, Minnesota, Montana, North Carolina (purchase mortgages), North Dakota, Oregon, Washington, and Wisconsin are regarded as non-recourse states.

³ This was accomplished by holding the individual loan characteristics at their respective means as calculated from the sample of defaulted loans at the time of default.

The views expressed in this article are those of the authors and not necessarily those of the Federal Reserve Bank of Richmond or the Federal Reserve System.



THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND ■ BALTIMORE ■ CHARLOTTE

www.richmondfed.org