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Recourse and residential mortgages: The case of Nevada

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ABSTRACT

The state of Nevada passed legislation in 2009 that abolished deficiency judgments for purchase mortgage loans made after October 1, 2009, and collateralized by primary single-family homes. In this paper, we study how this change in the law affected equilibrium mortgage lending. Using unique mortgage loan-level application data and a difference-in-differences approach that exploits the qualification criterion, we find that the law change led to a decline in equilibrium loan sizes of about 1 to 2 percent. There exists some evidence that mortgage approval rates also decreased for the affected loan applications. These results suggest that making the deficiency judgment law more default friendly in Nevada generated material cost on borrowers at the time of mortgage origination.

1. Introduction

In the United States, state laws govern residential mortgage defaults and house foreclosure processes. In most states, mortgage loans are recourse loans – that is, lenders can apply the difference between mortgage balance and proceeds from foreclosure sales to delinquent borrowers' other assets or earnings, a process also known as deficiency judgments.[1] Theory predicts that recourse should deter default since default puts delinquent borrowers' other assets at risk.[2] This prediction has prompted some discussion of using deficiency judgments to reduce mortgage defaults during the recent mortgage crisis.[3,4] Protections to defaulters in the form of no deficiency judgments, however, can impose substantial costs on lenders. If lenders try to recoup these costs by reducing approval rates or restricting loan sizes, laws intended to protect homeowners in distress may impose costs on all borrowers.

In this paper, we conduct a unique event study using proprietary mortgage loan-level application data to test whether changes in deficiency judgment laws affected mortgage loan approval rates or approved mortgage loan sizes. In 2009, Nevada passed legislation that made significant changes to its deficiency judgment law. For homeowners who entered into a mortgage in conjunction with the purchase of a single-family primary home after October 1, 2009, their mortgage lenders will not be able to pursue a deficiency judgment if the house is taken in a foreclosure. Our analysis is based on the difference-in-differences identification that exploits this qualification criteria: first-lien refinance loans for primary residences are not affected by the law change. Specifically, we assess the differential change in the approval rates as well as approved loan sizes of the treatment group (purchase loans) relative to the control group (refinance loans) around the new law implementation date. The identification assumption behind this comparison is that, in the absence of the legislative change, the approval rates and approved loan sizes in the control and treatment groups would follow similar patterns (up to a constant difference).

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[1] See Table 1 in Ghent and Kudlyak (2011) for a summary of different state recourse laws.

[2] See, for example, Ambrose et al. (1997), and Corbae and Quintin (2015).

[3] See Adam Levitin's blog post, "The Role of Recourse in Foreclosures," at http://www.creditslips.org/creditslips/2008/12/the-role-of-rec.html.

[4] The literature finds mixed evidence. For instance, Clauretie (1987) shows that whether a state allows for deficiency judgments does not affect mortgage default rates significantly, consistent with the observation that deficiency judgments are not carried out often in practice due to the high cost associated with pursuing them (Ambrose and Capone, 1996; Leland, 2008, and Brueggeman and Jeffrey, 2011). By contrast, Ghent and Kudlyak (2011) show that recourse affects default by lowering borrowers' default sensitivity to negative equity and home value.

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Our analysis shows that the law change is associated with a decline in approval rates of about 3 percent and in approved loan sizes of about 1 to 2 percent for the affected purchase loans. As a robustness check, we conduct additional experiments where we use first-lien purchase loans for primary residences from neighboring counties in other states as our alternative control group. Those states did not pass any significant legislative changes concerning foreclosure laws during our sample period. We continue to find that the equilibrium loan sizes declined for Nevada purchase loans after its law change. Finally, we conduct a placebo test using loans in counties that neighbor Nevada and that did not experience changes in deficiency judgment laws. There, we do not find any evidence of significant changes in approval rates or loan sizes for purchase loans after October 2009.

Our paper joins the large literature that analyzes the impact of various aspects of state laws on lending cost. For example, Meador (1982) analyzes the effect of state foreclosure laws on mortgage rates and finds that contract rates are generally higher in states where the law extends the length and expense of the foreclosure process. Clauretie and Thomas (1990) and Ciochetti (1997) document greater lender costs in states that require judicial foreclosure and statutory right of redemption. Lin and Michelle (2001) investigate the relationship between bankruptcy exemptions and the availability of credit for mortgage and home improvement loans. They find that applicants are more likely to be turned down for both types of loans when they live in states with unlimited rather than low homestead exemptions. Berkowitz and Hynes (1999), on the other hand, show that in the 1990s high homestead exemption levels did not tend to increase mortgage rates or increase the probability of being denied a mortgage. Pence (2006) examines the effect of foreclosure laws on the size of approved mortgage loans and finds that, everything else the same, lenders approve smaller loans in default-friendly states. To the best of our knowledge, our paper is the first to evaluate the effect of a legislation change in deficiency judgments. Our natural experiment provides variation in deficiency, which allows cleaner identification than the state-level variation in existing recourse laws. The previous literature has typically used the latter approach; however, state recourse laws change only infrequently.

The rest of the paper is organized as follows. Section 2 discusses the law change in Nevada and its potential impact on debtors and creditors. Section 3 presents our data source. Section 4 reports our empirical analysis, and Section 5 concludes.

2. The Nevada deficiency judgment law

2.1. The Nevada deficiency judgment law

Until recently, Nevada was a recourse state, since it allowed lenders to sue their borrowers to get a deficiency judgment within six months following foreclosure for all mortgage loans. The amount of the judgment, however, was limited to the lesser of the difference between the total debt and fair market value of the home, or the difference between the total debt and foreclosure sale price.[5] Before awarding a deficiency judgment, the court would hold a hearing to receive evidence from the lender and the borrowers concerning the fair market value of the property as of the date of the foreclosure sale. The lender must give the borrowers notice of the hearing 15 days prior to the hearing. The court would appoint an appraiser to appraise the property if the lender or borrowers made a request at least 10 days before the hearing date.[6]

[5] Nev. Rev. Stat. § 40.459.

[6] Nev. Rev. Stat. § 40.457.

The deficiency lawsuit is similar to a lawsuit to recover an unsecured debt, such as credit card debt. If the lender wins the case, the court will issue a judgment ordering the borrowers to pay off the deficiency. If the borrowers ignore this court order, the lender can use the deficiency judgment to place liens on other property that the borrowers own, garnish their wages, or freeze their bank accounts. In the Appendix, we provide information on the actual practice of deficiency judgment in Clark county, Nevada.[7,8] Based on our collected data, the fraction of foreclosed loans that ended up with a deficiency judgment has been declining over time, from 20 percent in 2000 to 0.12 percent in 2013.[9] The sharpest decline occurred in 2007, coinciding with the onset of the mortgage crisis. In contrast, the amount of awarded judgment as a fraction of mortgage outstanding has been increasing over time, with the median increasing from 9 percent in 2000 to 15 percent in 2013.

Since the mortgage crisis began in 2007, Nevada, like many other states, has begun to implement new laws to mitigate foreclosures. In 2009, eight laws were passed in Nevada alone. Table 1 summarizes the eight laws. As can be seen, almost all laws made foreclosures more cumbersome and costly by either imposing additional regulatory procedures or assigning more rights to owners or renters during a foreclosure. The only exception is Assembly Bill (AB) 140, which also increased owners' and tenants' responsibility to maintain the property during the foreclosure sale.

This paper concerns one of the most important new laws: AB 471. This bill made significant changes to Nevada's deficiency judgment law. Under the new legislation, a financial institution holding a residential mortgage may not be awarded a deficiency judgment if the following four circumstances apply: the real property is a single-family house owned by the debtor, the debtor used the money loaned from the bank to buy the house, the house was owner occupied, and the loan was never refinanced. What this means is that, for many homeowners who enter into a mortgage in conjunction with a house purchased after October 1, 2009, their mortgage lender will not be able to pursue a deficiency judgment if the house is taken in a foreclosure. Rather, upon foreclosure, the risk that the house has depreciated in value shifts back to the bank. Mortgages that do not satisfy these conditions remain subject to the prior law.[10]

Nevada passed no other laws in 2010 (the 26th Special Session). In the summer of 2011, to combat robo-signing, the Nevada legislature passed a set of pre-foreclosure rules that essentially require the big banks to prove their claim of title before the foreclosure can take place (AB 273, AB 284, AB 388, and Senate Bill (SB) 414). These changes made the judicial foreclosure process more attractive to banks, as they allowed them to sidestep the new robo-

[7] Clark County is by far the most populous county in Nevada (it contains Las Vegas). Loans in Clark County account for more than 75 percent of total mortgages in Nevada between 2000 and 2013. We scraped the website of the Clark County District Court to obtain information on deficiency judgments contained in their case files. Information for the other counties were not easily accessible via the internet.

[8] We thank Yuan Yuan for her generous help in collecting this information.

[9] Quintin and Yuan (2015) find in their study of foreclosure sales in seven counties in Illinois between mid-2008 and mid-2012 that about 2 percent end up with a deficiency judgment. Over that period, our numbers are smaller. There are several possible reasons for this difference. First, our sample includes both liquidation and real-estate-owned mortgages. Using the liquidation sample, however, only raises the probability to about 0.3 percent. Second, deficiency judgment was no longer allowed against purchase mortgages for primary residences made after October 2009. Finally, households in Nevada might have fewer assets than households in Illinois, making deficiency judgment suits not appealing to lenders.

[10] Aside from recourse, in Nevada, lenders may foreclose on mortgages in default using either a judicial or nonjudicial foreclosure process. The judicial process of foreclosure involves filing a lawsuit to obtain a court order to seek foreclosure and is used when no power of sale is present in the mortgage. The borrower has 12 months after the foreclosure sale to redeem the property. When a power-of-sale clause exists in a mortgage or deed of trust, the nonjudicial process is used. Borrowers have no right of redemption under the power of sale.