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Compulsory No-recourse in Mortgage Lending: A Bad Idea

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In spite of certain court decisions and statements to the contrary, most judges and observers in Spain consider that, in cases of insolvency, mortgage loans should be foreclosed, applying the debtor's unlimited liability clause that is typical of mortgages in this country. This means that delivery of the mortgaged property does not cancel the debt if the amount of the debt is greater than the value assigned to the property.

However, proposals to introduce compulsory rules limiting debtor's liability in future mortgages are often made, the idea being to adopt the pattern followed in the US for the minority of mortgages which, also because of legal restrictions, are contracted there without recourse.

This would be a mistake. If in Spain, as in most of the developed world, limited liability mortgages are not used, it is because creditors and debtors choose not to use them. They reject the limitation of liability, though it is allowed by the Law, because it would be damaging for both: not only would interest rise and the amount of loans decrease, but risk would increase and its allocation would also worsen.

It is the debtor who can best bear the risk associated with changes in the value of property because of the incentives provided by unlimited liability: he will be encouraged to make "specific" investments that are only of value to the owner; and he will be able to use personal guarantees that would be costly to set up through additional contracts, such as complementary personal loans. More importantly, he will be encouraged to make an effort to return the loan. If difficulties arise, he will strive to increase his income or will devote a larger proportion of his current income to paying off the mortgage. With limited liability, on the other hand, he would stop paying as soon as the property is worth substantially less than the debt. This would lead to the situation of strategic default that is plaguing certain US states—as much as 26%—and making it necessary to incur the high costs of foreclosure.

Banks would find it difficult to diversify the risk associated with unlimited liability. They cannot transfer it to other investors without aggravating the opportunism that stems from separating the granting of credit and the acceptance of risk. This has become clear in the crisis in the US, where the Treasury has just recommended that the grantors of credit should retain greater risk. Moreover, the fact that the banks are limited liability companies is of little relevance because of the high costs of bankruptcy, both private and public. And, if they have incentives to lend too much, they would anyway do so in the form of complementary personal loans.

These factors should lead us to conclude that unlimited liability is optimal on an individual scale, so it should only be prohibited if there is some serious, irreparable failure in the market, because of a lack of competition, negative externalities or contracting party irrationality.

With regard to competition, if limited liability mortgages were efficient, even a monopolistic bank would be keen to offer them as it could extract the additional profit via higher interest rates. In fact, failure might occur the other way round: what is worrying in the US is that, in the States where unlimited liability mortgages are illegal, the public deposit insurance (or, more specifically, the fact that this insurance premium is separate from the risk borne by each lender) is pushing banks to set a very low price for limitation of liability, leading to widespread underestimation of risk in the real estate market.

The same is happening regarding externalities as the crisis has also indicated that in the US limited liability mortgages produce two negative systemic effects. On the one hand, by stimulating strategic default, they are worsening recessions. This makes the negative externality caused by foreclosures when they are concentrated in a geographical area even worse. On the other, they are not taking advantage of the moderating effect exerted by the fact that debtors' rents are not perfectly correlated. This is especially serious when, during upward trends, many debtors expand their loans simultaneously, which means that when the market enters a recession, their insolvencies also all come at the same time.

It is true that mortgage loans are adhesion contracts, so it is questionable whether debtors are completely rational when they sign them. But if limitation of liability were efficient, competition between banks would lead them to offer it. Moreover, this is a salient, well-known clause. Debtors are unlikely to find it difficult to understand, and are unlikely to be less rational regarding this clause than others, such as teasing and variable rates.

Altogether, if unlimited liability generates good incentives, allocates risk well and does not seem to result from market failure, it is reasonable for it to be the universal pattern for mortgage contracts. Exceptions would be certain commercial transactions by business debtors in which the property generates a monetary income, making the situation very different.

Of course, the US is also exceptional. But the situation there is not so different from that of Spain or other EU countries because, in States in which there is effective contractual freedom, mortgages are also granted without limiting liability. Only in 11 States are the parties obliged to take out limited liability mortgages, largely to ensure that foreclosure will be efficient.

This trade-off between liability and foreclosure was present in English Law back in the 17th Century. That's how new these proposals are.

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