Mortgage Recourse Provisions and Housing Prices

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Abstract

In light of the large swings in housing prices in the United States in recent years, there has been considerable interest in trying to understand the various factors which led to the boom and bust of the housing market. In this paper, we explore the impact of the legal environment from provisions for mortgage default across U.S. states. To do so, we develop a rigorous general equilibrium framework which incorporates the possibility of strategic default among mortgage holders to study the implications of mortgage recourse for mortgage market and housing market activity. While housing demand should be higher in markets with less legal control, lenders also adjust the amount of mortgage credit provided. In order to begin to understand the empirical implications of our theoretical model, we use simple regression analysis on housing prices at the MSA-level using the Case-Shiller Home Price Index. Notably, our results indicate that supply-side factors in mortgage lending dominate the demand-side factors. That is, a lack of legal control regarding mortgage default did not contribute to the housing bubble. Instead, it appears that housing prices appreciated more in states which provided lenders with more protection. Therefore, states should carefully consider revising the bankruptcy provisions for housing. While policymakers might be tempted to believe that eliminating recourse provisions would encourage housing market activity, our work suggests otherwise as supply-side factors for mortgage funding appear to be critically important. Alternatively, policymakers might consider that protections for mortgage holders are crucial in order to protect risk-averse borrowers from weak housing market conditions. However, such protections are likely to exacerbate weakness in the housing market as intermediaries also seek to protect risk-averse depositors from mortgage-related losses.

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