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Recourse vs. Non-Recourse Loans

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If you are applying for financing to invest in a real estate, you have two loan options open to you in the form of recourse and non-recourse loans. While both have similarities related to the lenderâ€™s hold over the asset, there are significant differences. Knowing these can result in major benefits depending on your location and the funding option you decide to seek.

A recourse loan entitles the lender to go after the borrowerâ€™s personal assets for the amount owed by him even when there is collateral attached. Defaulting on a recourse loan gives the lender the power to take legal action to get their money back.

In contrast, with a non-recourse loan, the lender only has power to pursue the collateral via foreclosure if the borrower defaults on repayment. Based on this critical difference, borrowers prefer non-recourse loans while lenders prefer recourse loans.

Borrowerâ€™s benefit, lenderâ€™s risk

In recourse as well as non-recourse loans, the lender has the right to seize the asset used as collateral, which is usually the property purchased in conjunction with the loan. When the borrower defaults on either type of loan, the lender take title to the property and resell it to recover what they are owed. If the borrower owes more than what the property is worth, in a recourse loan, the lender can sue in the case of a default. With non-recourse debt, the lender has no choice but to write off the debt as a loss. Non-recourse loans are riskier for the lender.

While non-recourse loans may be more attractive to borrowers, they usually come at higher rates of interest and require high credit ratings. Even though defaulting on a non-recourse loan keeps the borrowers other assets safe, credit scores are often taken into account as a portion of the borrowerâ€™s overall financial profile.

Since the non-recourse lender must absorb the risk in case of a payment default, they carry out extensive analysis of the borrowerâ€™s financial picture before approving the non-recourse loan in order to minimize their risk.

One Scenario Where this Matters - Purchasing Real Estate in a Self Directed IRA

Given these two loan types, the IRS has mandated that any retirement account obtaining a loan must use a non-recourse loan. For investors who want to use a self-directed IRA to buy or hold real estate investments, a non-recourse loan is their only legal option for mortgage financing within the account. The investorâ€™s liability is limited to the down payment and any principal they have repaid on the loan.

Some Due Diligence Before Approaching a Non-Recourse Lender

Once you have decided this method of real estate investing is the right choice for you, and you need a non-recourse loan, shop around. Get details about the interest rates and the flexibility of the loanâ€™s terms, along with fees that may apply. Some lenders charge a valuation or early prepayment penalty. Also, check the rules and rates related to late payments.

Non-recourse loans are an excellent alternative if you are looking for a loan to remove further personal liability from repaying a loan.

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