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# The quality assurance role of seller financing: evidence from second mortgages[☆]

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**Abstract**

Quality problems that are known to the seller of a product, but will become known to the buyer only after the purchase have the potential to frustrate voluntary exchanges. Where the determination of quality after the sale is cut-and-dried, brand names and unconditional guarantees will bond contract performance. When the problem is more subtle or confounded by the extent of consumer inputs, requiring risk-sharing by the contracting parties, these bonding devices typically are not sufficient. Under the circumstances, seller financing may be an efficient contracting solution for bonding the quality dimension of the contract. This form of financing makes both the buyer and the seller share the risk that the product may not suit the buyer's needs in the way promised by the seller. This paper provides further empirical evidence on the quality assurance role of seller financing. We consider seller-financed *second mortgages* in the *National Association of Realtors* database. Seller financing in second mortgages may be a supplement to first mortgages supplied by conventional lenders. The role of seller financing as a quality assurance mechanism in second mortgages is more complex than its role in first mortgages, but is also less subject to an alternative interpretation of credit

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rationing than is its role in seller-financed first mortgages. To avoid further complexities, we do not consider second seller financing transactions that supplement first assumption mortgage transactions.
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## 1. Introduction

Why does a seller provide financing to the buyer in a property exchange? While the volume of seller-financed transactions in property exchanges is not large, it has been around for a long time and present in many countries. Furthermore, trade credit in retailing and business-to-business commodity exchanges is a form of seller financing. Its volume is indeed quite large. The survival of seller financing, despite the breathtaking pace of financial innovation in recent decades, indicates that this form of financing continues to be a viable market mechanism and that whatever its functions may be, they are of continuing and encompassing importance to consumers.[1] Surprisingly, not only is our understanding of the role of seller financing – especially in property exchanges – limited, there is also very little empirical evidence on this topic.[2]

Following Laband and Maloney (1994), we suggest that seller financing in residential real estate exchanges is a quality assuring signal that has the potential to mitigate the informational asymmetry problem regarding the quality of the property, under conditions of seller and buyer opportunism. Laband and Tirtiroglu (2004) offer empirical evidence in support of this argument, using data on first mortgages available in the *National Association of Realtors* database for the period 1984–1996. These recent advances take us beyond the conventional explanation of credit rationing as a reason for seller financing in property exchanges.

In this paper, we consider seller-financed *second* mortgages in the National Association of Realtors' database. Seller financing in second mortgages may be a supplement to first mortgages supplied by conventional lenders. The role of seller financing as a quality assurance mechanism in second mortgages is more complex, but also is less subject to the alternative interpretation of credit rationing than is

[1] For example, payment for a meal in a sit-down restaurant typically occurs after the meal is consumed and one can view no payment before or during consumption of the meal as a form of very short-term seller financing. If the meal is not satisfactory, the customer may balk at paying the bill and the seller may, for his part, offer the meal at no charge to the customer. On the other hand, in fast food chains and restaurants that offer rather standardized quality for a meal, payment for a meal occurs in advance of consuming the meal. For more on the timing of payments, see Faith and Tollison (1981).

[2] Petersen and Rajan (1997) offer empirical evidence on the reasons for trade credit transactions for small U.S. firms. Their evidence suggests that firms use more trade credit when credit from financial institutions is unavailable. They, however, acknowledge that their conclusions are limited since their data are from only one year, a shortcoming that prevents them from testing the quality assurance hypothesis. They note (p. 690) that: "the single most important step for future research is to examine the determinants of trade credit over time. More detailed data will permit researchers to investigate the price discrimination and quality guarantee hypotheses more fully."

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