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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Kyle Herkenhoff, Researcher for UCLA Ziman Center for Real Estate, debunks the myth of "strategic default" with new data suggesting that job loss has been the major cause of defaults.

Debunking the Myth of Strategic Default

New Data Suggests That "Strategic" Defaults During the 2007-2009 Recession Were Relatively Rare

By Kyle Herkenhoff, Researcher, UCLA Ziman Center for Real Estate

Were defaults driven purely by negative equity during the 2007-2009 recession? Or were households defaulting because of liquidity constraints (a lack of cash-on-hand) stemming from job loss?

> **"Temporary mortgage modifications do not provide a long-term solution to default. Rather, the key to stemming mortgage defaults is to promote re-employment and higher earnings."**

Even several years after the National Bureau of Economic Research (NBER) marked the trough of the recession (June 2009), there is still considerable debate about the causes of default. Using a new data supplement from the Panel Study of Income Dynamics (PSID), my coauthors (Kris Gerardi, Lee Ohanian, and Paul Willen) and I found that job loss is the main "single trigger" determinant of default.

These findings have important policy implications. They suggest that temporary mortgage modifications do not provide a long-term solution to default. Rather, the key to stemming mortgage defaults is developing policies that promote re-employment and higher earnings, such as payroll tax cuts.

More specifically, we found that job loss increases the probability of default between 5 to 13 percentage points. Severe negative equity (-20% or more) also increases the probability of default by 5 to 18 percentage points. But the impact of severe negative equity on default drops significantly in magnitude when liquid asset positions are taken into account. Furthermore, we found evidence for the "double trigger" event of job loss and negative equity, as well as job loss and severe negative equity. Specifically, we found that the joint occurrence of both job loss and negative equity raises the unconditional default rate by 11.3% over and above either trigger on its own.

A striking finding of the empirical analysis is on the frequency of strategic default, which is typically defined as default by borrowers who have sufficient resources to make the mortgage payment. As a suggestive measure, we looked at whether or not defaulting households with negative equity have enough liquid assets to make their mortgage payment.

We found that strategic default is rare in the PSID data. In particular, only 13.9 percent of defaulters in the PSID had sufficient liquid assets to make a mortgage payment. We confirmed the rarity of strategic default using data from the SCF which shows that only 6 percent of defaulters have sufficient liquid assets to make one mortgage payment. These findings suggest that strategic default is not a major factor in understanding recent mortgage default decisions, but rather that defaulters may have few options other than to default.

This article is based on the 2013 UCLA Ziman Center for Real Estate Working Paper, "Unemployment, Negative Equity, and Strategic Default" by Kristopher S. Gerardi, Kyle F. Herkenhoff, Lee E. Ohanian, and Paul S. Willen.