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The Depth of Negative Equity and Mortgage Default Decisions

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Abstract

A central question in the literature on mortgage default is at what point underwater homeowners walk away from their homes even if they can afford to pay. We study borrowers from Arizona, California, Florida, and Nevada who purchased homes in 2006 using non-prime mortgages with 100 percent financing. Almost 80 percent of these borrowers default by the end of the observation period in September 2009. After distinguishing between defaults induced by job losses and other income shocks from those induced purely by negative equity, we find that the median borrower does not strategically default until equity falls to -62 percent of their home's value. This result suggests that borrowers face high default and transaction costs. Our estimates show that about 80 percent of defaults in our sample are the result of income shocks combined with negative equity. However, when equity falls below -50 percent, half of the defaults are driven purely by negative equity. Therefore, our findings lend support to both the "double-trigger" theory of default and the view that mortgage borrowers exercise the implicit put option when it is in their interest.

Keywords: Housing, mortgage default, negative equity

JEL Classification: D12, G21, R20

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