

Contagious Defaults in Credit Markets - an Experimental Analysis

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The recent financial crisis has demonstrated forcefully that the borrowing behavior of households is a key source of instability to the financial sector and the real economy. Households, for example in the US, Ireland or Spain, took on excessive mortgage debt prior to the crisis. While lax lending standards and monetary policy may have fuelled the buildup of household leverage from the supply side, many households were prepared to take substantial risks. In particular, households seemed willing to accept the possibility that interest rates would rise significantly or decreasing house prices would leave them with higher debt service burdens and/or negative home equity. Between mid-2006 and end 2008 house prices in the US fell by 20%, with the result that almost 15% of US mortgages loans were in default.

It is unclear to what extent the wave of mortgage defaults in the US (or Ireland or Spain) was driven by the inability of homeowners to meet mortgage payments, or by strategic default to escape negative equity. In view of policy measures to avoid and contain future crisis (e.g. the design of consumer bail-out policies) it is important to understand whether mortgage defaults are predominantly driven by inability-to-repay or by strategic behavior. It is especially important to understand the role of social norms in containing strategic default. In particular, it needs to be studied to what extent social norms which foster loan repayment may collapse in the event of adverse economic conditions, leading to contagious loan defaults.

The object of this project is to identify economic environments and information conditions in which strategic loan defaults increase and become contagious. We will provide experimental evidence, which allows us (i) to identify the conditions under which strategic defaults emerge, (ii) to study the extent to which individual moral constraints preventing default are affected by aggregate default rates in a credit market, and (iii) to disentangle the direct effect of adverse economic conditions on strategic default from contagion of such defaults due to the observation of strategic default by other borrowers.

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Fields of Research

Experimental and Behavioral Finance

Finance and Society

Financial Institutions