The Imitation Game: How Encouraging Renegotiation Makes Good Borrowers Bad

Sean Flynn (Tulane University), Andra Ghent (University of North Carolina, Chapel Hill), and Alexei Tchistyi (Cornell University)

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Policies to encourage mortgage loan renegotiation during times of widespread financial distress are common. During the 2008-2009 financial crisis, policymakers sought to avoid massive waves of residential mortgage defaults by encouraging lenders to modify delinquent loans. Similarly, in the wake of the COVID-19-induced market turmoil, policymakers have encouraged commercial real estate lenders to engage in forbearance and modifications.

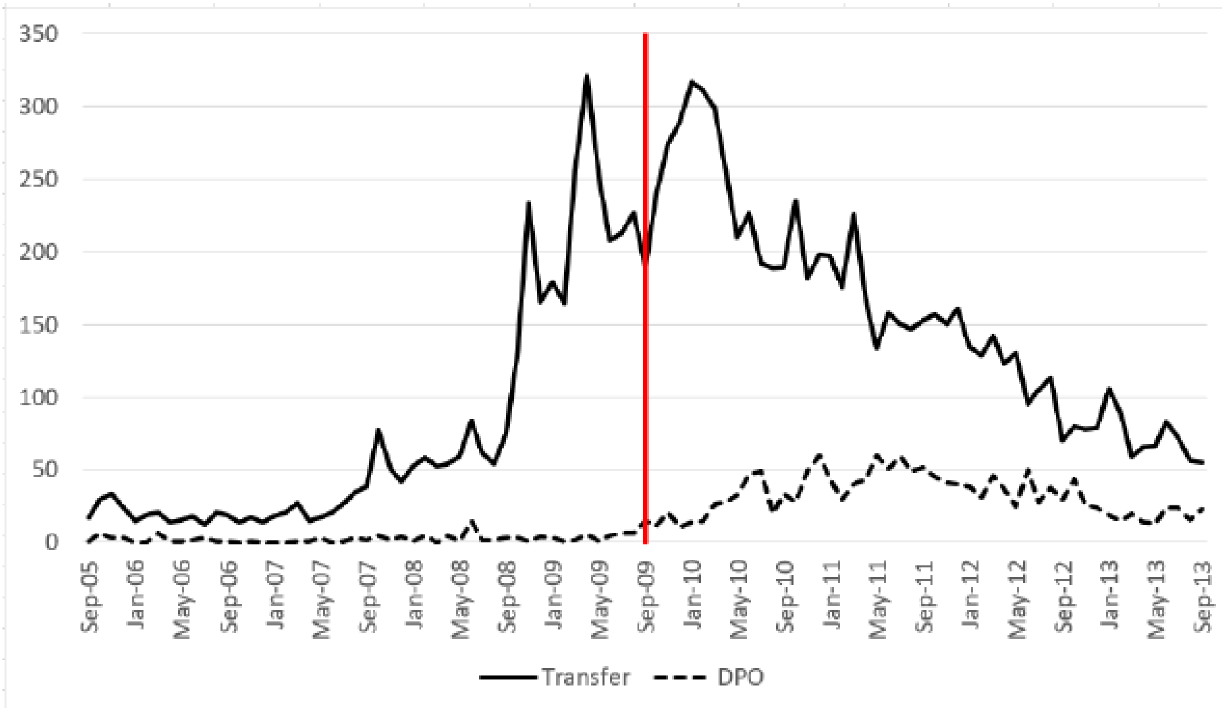
Despite policymakers' efforts, modifications during the 2008-2009 crisis were infrequent and did not impact many borrowers. Particularly notable was the lack of principal reductions, which are modifications in which lenders agree to accept repayment of less than the remaining balance on the loan. One explanation for this is that lenders feared that offering such modifications to delinquent borrowers would encourage other financially healthy borrowers to default on their mortgage "strategically" in order to become eligible for modifications.

This study addresses the extent of such strategic borrower behavior in the CMBS market. We ask whether CMBS borrowers behave strategically in an attempt to obtain principal reductions (known as discounted payoffs or "DPOs" hereafter) from lenders. We focus on DPOs specifically because, unlike temporary modifications such as interest rate reductions or term extensions, principal reductions result in immediate and sizable benefits to borrowers. Moreover, borrowers are able to retain the property following a DPO.

Our empirical analysis establishes the impact of DPOs on the likelihood that a borrower's loan is transferred into special servicing. Transfer into special servicing is a necessary condition for borrowers to engage with lenders in an attempt to renegotiate loan terms, hence we consider transfers as the key type of borrower behavior. We specifically ask whether a given borrower is more likely to be transferred into special servicing *after* they observe their special servicer negotiate a DPO on a *different loan.*

To aid in our identification of the impact of DPOs on loan transfers, we exploit a 2009 IRS rule change that increases the ability of borrowers to be transferred into special servicing absent any financial distress. This rule change was implemented in the wake of the 2008-2009 financial crisis in order to encourage lenders to modify distressed CRE loans.

The following graph plots the number of DPOs and transfers over the time period in our study, with a red vertical line placed in September 2009, when the tax rule change occurred:



We find that, following this rule change, borrowers are significantly more likely to be transferred into special servicing after their special servicer negotiates a DPO for another borrower. They are also more likely to become seriously delinquent (60+ days past due). Despite this, we show that loans that are transferred are more likely to fully pay off ex-post, which suggests that a subset of borrowers who transfer are high quality.

Overall, our results are consistent with CMBS borrowers strategically obtaining transfers into special servicing after observing a DPO on another loan. This strategic behavior occurs after a rule change that encourages modification and renegotiation of distressed loans. Thus, our study points to important unintended consequences of loan modification incentives.

This is particularly important in the wake of the COVID-19 induced CRE market turmoil. In April 2020, the IRS approved a rule change designed to encourage CMBS loan forbearance and modifications. This rule change directly parallels the rule change we exploit in our study. Hence, our paper suggests this recent rule change carries the risk of inducing financially healthy CMBS borrowers to transfer in an attempt to obtain favorable modifications.