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Underwriting Fraud Imperils Commercial Mortgage Bonds

Inflated underwriting could turn the reboot of commercial mortgage-backed securities into a crash

Texas McCombs · Follow

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Based on the research of John M. Griffin

Sixteen years ago, bonds based on risky residential mortgage loans fueled the crash that brought on the Great Recession. In new research, John M. Griffin, Texas McCombs professor of finance, similar risks in a

security reputed to be much safer: commercial mortgage-backed securities, or CMBS.

CMBS pool together loans on commercial properties such as office buildings and shopping centers. They depend on predictable flows of lease and rental income.

But in analyzing $650 billion worth of the underlying loans, Griffin and Alex Priest, a McCombs Ph.D. graduate now at the University of Rochester, found the income flows might not be so reliable.

Nearly a third of the loans significantly overstated expected earnings, when compared with the properties' historical numbers. That meant the CMBS were more vulnerable to default if the economy soured and renters missed payments.

"If you get an economic shock, then you're going to see distress, and you're going to see the true quality of the way a security was created," Griffin says.

A recent economic shock underlines his point. When COVID-19 lockdowns closed many offices and malls, between April 2020 and April 2021, 32% of CMBS loans experienced financial distress, such as missing payments or threats of foreclosure.

That distress eased as the pandemic ebbed, but Griffin says he worries about the next financial crisis if the lesson isn't learned.

"If a security was not created in the way it was promised, someone's going to take a loss," he says. The losers could be not only investors, but also taxpayers and retirees.

"We will likely start seeing the effects of the fraud when interest rates rise and incomes on the properties fall," he adds. "Both scenarios seem to be happening in 2023."

Fingerprints of Fraud

Griffin specializes in forensic finance: analyzing big data for indicators of possible financial fraud. In past research, he's found fingerprints of manipulated numbers everywhere, from a stock index to a cryptocurrency.

Some of his published papers have looked at residential mortgage-backed securities and their role in the 2007–08 financial crisis. A common finding was misreporting, such as overstating the appraised values of houses and apartments.

CMBS, by contrast, had fared well through the Great Recession. Subsequent reforms had supposedly made them even safer — so much so that the industry nicknamed the rebooted product CMBS 2.0.

Griffin wasn't so sure this greater trust was justified. "A lot of the same banks were putting these instruments together," he says. "What was different about them? Were they actually better?"

Overestimating Income

To find out, he and Priest analyzed 39,522 loans that had been pooled into CMBS between 2013 and 2019. They compared each loan's projected income with its actual income during the first year after it was made.

They found that 29% of the loans overstated projected income by at least 5%, a level commonly considered material by investors.

For eight loan originators, numbers were considerably higher. At least 35% of their loans overstated income by 5% or more. They included Wall Street names such as Goldman Sachs, Citigroup, and Morgan Stanley.

"It seemed like a lot of banks were actually playing by the rules fairly well, but there was a subset that definitely wasn't," says Griffin.

He also found evidence that the rule-breaking was deliberate. At the lenders with the highest levels of overstatements, exaggerations went up over time. So, even before the COVID crisis, parts of the CMBS market had problems.

“It wasn’t just bad luck in one year,” he says. “These banks were consistently more aggressive in overstating income.”

Lending Incentives Create Investing Risks

Lenders have strong economic incentives to inflate income projections, Griffin explains. Higher income leads to higher property valuations and bigger loans, which generate bigger fees.

He cites a Hilton hotel in Iowa. A CMBS prospectus overstated its historical income by $200,000. At a 5% capitalization rate — a common ratio of income-to-property value — the property’s alleged value would rise $4 million.

When such an inflated loan gets packaged into a CMBS, it creates bigger risks for investors and others because:

—The property may generate less cash flow than anticipated and is more prone to default in a downturn.

—If the property gets foreclosed, it may sell for less than expected.

Investors who buy CMBS are largely pension funds and insurance companies, Griffin notes. “Who takes the losses for those pension funds? The pensioners and the state’s taxpayers.”

Safeguards: Not So Safe?

Regulatory changes since the Great Recession are supposed to make CMBS safer. But Griffin questions how well they’re working.

A key rule, which took effect in 2016, aims to discourage income overstatement by making lenders share the losses if a loan goes bad. When selling a loan to another party, a lender must keep a 5% sliver.

But the new rule includes a significant loophole. It allows lenders to sell off that residual piece to certain buyers.

As a result, the researchers found, the change had little practical effect. Before the rule, lenders kept the residual piece in only 3.4% of loans. After the rule, the number was 5.7%.

"Our paper found that the policy didn't matter," Griffin says. "When you have policies made, and people in the industry are meddling with the policies, the bark is often bigger than the bite."

Caution on CMBS

The lesson for investors, Griffin says: Don't assume a CMBS is safe, particularly if the originator has a history of overstating income.

"If you're buying securities from a bank with aggressive practices, you might want to be cautious," Griffin says. "You might not buy securities from them, or you might require a much higher yield."

That's particularly true today, he adds, when the CMBS market is being squeezed by high interest rates and increased office vacancies. During the first six months of 2023, the volume of new CMBS dropped 68% from the previous year, while distressed commercial assets rose 10%.

"We find that structured finance 2.0 is having some of the exact same issues as 1.0," Griffin warns. "People don't pay enough attention to these things until they blow up. Then we could see massive losses in this space."

"Is COVID Revealing a Virus in CMBS 2.0?" is published in The Journal of Finance.

Story by Steve Brooks

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