The Role of Insurance in Debt Renegotiation: Evidence from Mortgage Market

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Abstract

This paper studies the effects of mortgage insurance on the likelihood of loan modification. Mortgage insurance enables the mortgage holders to get compensation for the loss in mortgage investment resulting from borrower's default. If a loan becomes delinquent, the borrower may apply for loan modification. According to moral hazard theory, mortgage holders are less likely to accept loan modification if mortgages are guaranteed by mortgage insurance, because their loss can be paid by the insurance company. We empirically test this effect using datasets including detailed information of loan origination and performance. We find that higher insurance coverage leads to lower likelihood of modification and the magnitude of this moral hazard effect is significant and changes with insurance companies' credit quality. This research is the first paper testing the role of insurance in loan modification and is expected to help us better understand the reason that lenders are reluctant to modify loans, which is one important factor of the higher liquidation rate.