Will Real Estate be the Next Victim of Rising Interest Rates?

What D&O and E&O Underwriters Need to Consider

– Blair Bartlett

Since the collapse of Silicon Valley Bank (SVB) occurred in early March, there has been much deliberation about the root cause that led to its failure. Poor risk management, inadequate regulatory oversight, social media activity, and an ensuing lack of confidence spurring depositors to withdraw their cash from the bank have all been cited as contributing factors. One undisputable factor that ultimately contributed to SVB's demise was the historic pace of interest rate increases by the United States Federal Reserve (See Chart I).[1]

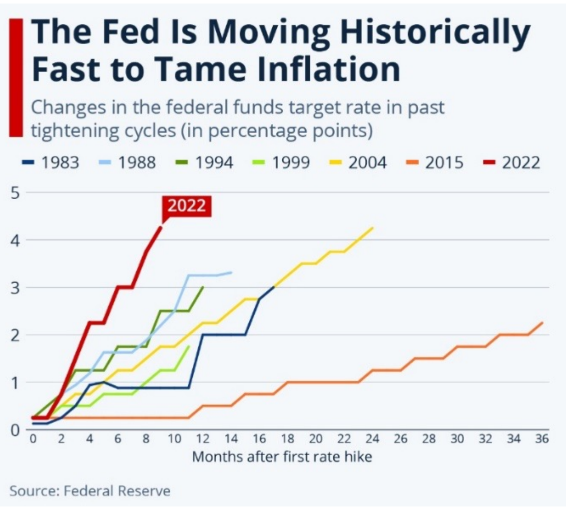


Chart 1

The Most Recent Changes in The Federal Funds target Rate Have Occurred Much Faster Than In The Past.

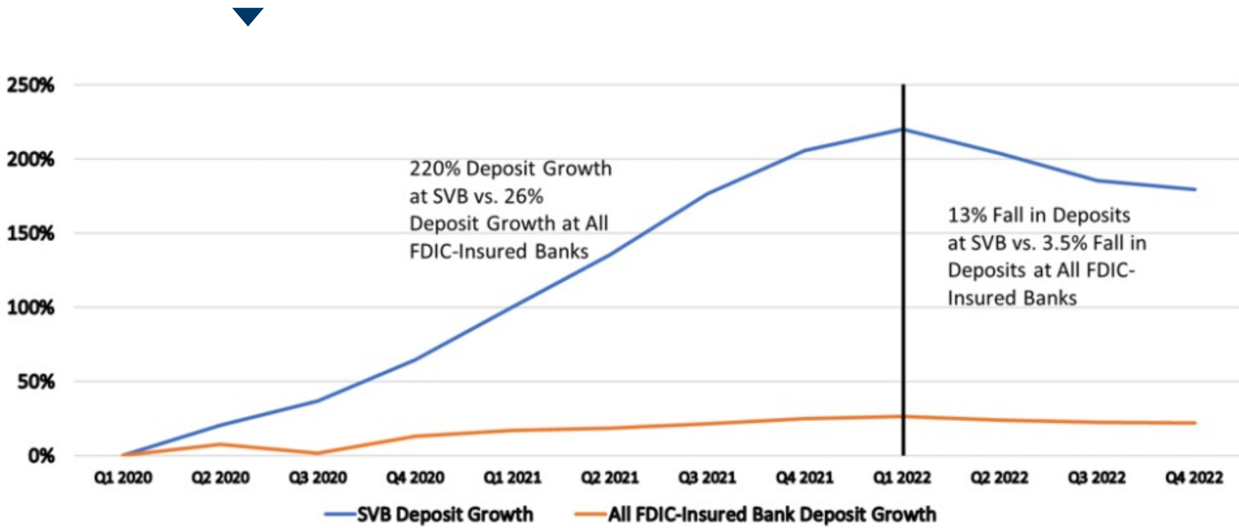
SVB was particularly vulnerable to rising interest rates due to a combination of the timing of its robust deposit growth (see Chart II)[2], and the low interest rate environment in which it deployed those deposits into investments in fixed income products with longer dated maturities. For months, economic pundits had feared that the Fed would continue to raise interest rates in their battle against inflation until something broke.

Well, something broke, and it doesn't feel like the Fed is done raising interest rates because inflation remains an issue. Management Liability underwriters were initially concerned about how the SVB collapse would affect their portfolios, focusing primarily on other banks and venture capital-backed tech and fintech companies. Another area that has been affected by rising interest rates, and that is particularly vulnerable to further interest rate increases, is the real estate sector. The strength of single family and multifamily residential real estate was fueled by the same low interest rate environment that allowed for startups to raise so much money in

2020 and 2021. As rates continue to rise, underwriters need to be prepared for the very real possibility that real estate investment managers will face difficulties not seen in some time.

Chart II

SVB Deposit Growth Compared to That of All FDIC-Insured Banks



Source: Company Filings as of 12/31/22, FDIC Quarterly Banking Profiles as of 12/31/22

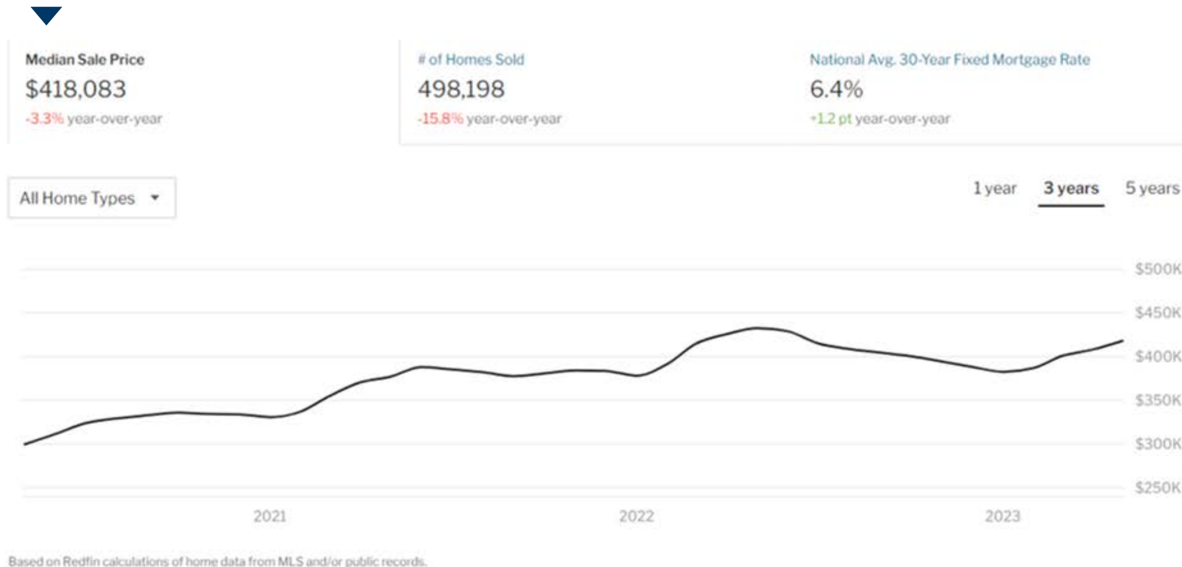
Housing Market Is Still Going Strong and Driving Interest Rate Increases

According to the Bureau of Labor Statistics, "The Consumer Price Index for All Urban Consumers rose 0.1% in May 2023 (seasonally adjusted) after rising 0.5 %in January, .4% in February, .1% in March, and .4% in April."[3] Of the 4.0 % increase in the index for all items from May 2022 to May 2023, shelter prices were one of the largest contributors, rising 8.0% over the last 7 months. Despite rising mortgage rates, the housing market remains strong.

Mortgage rates have jumped from 4.2% in March of 2022 to 6.7% in June of 2023. Meanwhile, median home sale prices have only fallen 3.3% during that time period and have been on the rise in each of the past two months – increasing from $382,000 in January of 2023 to $418,083 in May of 2023.

Chart III

3-Year Overview of US Housing Market
(All Home Types)



Source: [United States Housing Market & Prices | Redfin]

Bottom line is the supply/demand dynamic in housing favors increasing prices. Many believe the Federal Reserve will continue raising interest rates in their battle against inflation until they have broken the strength in the housing market, including the multifamily rental market. The May 2, 2023, .25% interest rate increase is an indication that rate increases will likely slow, but not necessarily stop until the Fed has achieved its goals.

Tightening Credit in the Commercial Real Estate Space

Banks may ultimately, if inadvertently, aid the Federal Reserve in their battle against inflation in the housing market. It has been speculated by many that in the aftermath of the SVB failure, banks will take a more conservative approach to lending. Goldman Sachs recently "lowered their forecast for U.S. 2023 fourth-quarter GDP growth (year-over-year) by 0.3 percentage point to 1.2%. The new estimate incorporates expectations for tighter lending and reflects, in part, a larger downgrade to investment spending."[4] How is that expectation playing out in the small- and medium-size banks that play an important role in the American economy? Lenders with less than $250 billion in assets account for roughly 50% of U.S. commercial and industrial lending, 60% of residential real estate lending, 80% of commercial real estate lending and 45% of consumer lending, according to a report by Goldman Sachs economists Manuel Abecasis and David Mericle[3]. To the extent that the banking stress that started with the resolution of Silicon Valley Bank has an impact in lending, it's likely to be concentrated in a subset of small- and medium-sized banks.[3] Those banks will likely increase mortgage rates, require higher equity contributions from buyers, and include stricter financial covenants. This action could take potential buyers out of the market, cutting into the demand side of the equation.

In fact, higher interest rates have already caused a decrease in sales in the multifamily market. According to Kevin Kovachevich from District Capital, a commercial real estate lender in Detroit, "The rising interest rates have significantly impacted the flow of money. Unless you absolutely have to, you don't want to borrow right now. The rates took such a significant move upward that the cost of borrowing has exponentially gone up. The monthly rents have not followed. Those prices remain the same. You have a situation where the rates rose so quickly that sellers haven't had time to adjust. Sellers still want prices from 2022. Buyers are saying that the cost of their capital has gone through the roof and that sellers need to adjust."[5]

So, it seems the real estate market is at a bit of a standoff. Transactions do not make sense for buyers that don't want to pay top of market prices and finance it with debt that carries interest rates that have not been seen in 15 years. Meanwhile, sellers are not yet willing to reduce prices. For the economics to make sense for buyers, prices will have to come down to allow for attractive enough CAP rates to get deals done. Industry experts are expecting valuations, which have just begun to decline, to fall further.

The Impact on Refinancing Calculations

With strong underlying fundamentals (high occupancies, shortage of housing, and high rents) persisting, there will have to be some sort of impetus forcing sellers to the market. This could come when multifamily property owners are faced with refinancing debt. According to Sam Tenenbaum, Director, Multifamily Insights at Cushman & Wakefield, "In each year from 2022-2029, more than $100B in debt matures, except for the year 2027 when $98B comes due. For context, about $75B came due in 2021, the highest figure recorded in history. So every year through 2029 is scheduled to surpass the all-time high mark."[6]

This coming wave of debt maturities will force property owners to make a decision whether to refinance or sell. For some, refinancing will not be an attractive option as it may require investors to put down additional equity or face less favorable terms that will cut into the profitability of the property.

The decreased profitability will drive down valuations. So the day of reckoning will certainly come at some point for multifamily property investors. How long and how severe of a downturn remains to be seen, and it will be greatly impacted by how high and for how long the Fed continues to raise interest rates.

Underwriters Beware

Multifamily properties have been the darling of the commercial real estate industry for quite some time, and underwriters of Financial Institutions Management and Professional Liability insurance for this segment have been able to rely on it consistently as a preferred class in the real estate fund space. However, this space should receive greater scrutiny going forward as it now looks increasingly vulnerable. While it is unlikely that carriers will abandon this segment, underwriters do need to perform a deep dive on the portfolio of multifamily real estate investment managers to identify any properties that could be at risk. Underwriters will typically look at occupancy, net operating income, debt service coverage ratios and distribution payments to get a feel for the health of a property. Now, however, underwriters need to focus particular attention on the debt maturities of each property, as the past profitability of a property is unlikely to be repeated in the future.

Real estate investment managers with near-term maturities will have to make tough decisions whether to refinance or to sell, and both could lead to painful outcomes for investors. Refinancing at higher rates will reduce distributable income, dragging down the internal rate of return (IRR). Selling at lower valuations will reduce the exit multiple portion of projected IRRs for investors. If the real estate investment manager structures the investments as single purpose vehicles or entities (SPV / SPE) as opposed to a more diversified Fund structure, the pain could be more acute.

Management and Professional Liability underwriters should be on the lookout for "problematic" properties – those with low occupancy, poor profitability, excessive debt, floating rate debt or near-term debt maturities – within an investment manager's portfolio and will likely seek to insulate themselves from the exposure those properties present.

Underwriters should seek additional information and answers about "problematic" properties, and if the answers are not satisfactory, may look to add exclusions to the policy to wall off that exposure.

Brokers and buyers of insurance in this segment should be prepared for increasingly difficult renewals as the Fed continues its battle against housing costs with the only weapon it has… interest rates.

Blair Bartlett is the Vice President of Financial Institutions in Crum & Forster's Executive Risk Division. He began his career as a floor broker on the American Stock Exchange (NYSE), before moving into insurance 17 years ago. Blair has focused exclusively on financial lines underwriting and is considered an industry expert on Financial Institutions' Errors & Omissions and Directors & Officers liability.

1. https://www.statista.com/chart/28437/interest-rate-hikes-in-past-tightening-cycles/#:~:text=Coming%20off%20historically%20low%20interest,the%20fastest%20in%20four%20decades
2. https://www.capitaladvisors.com/why-svb-was-unique/
3. https://www.bls.gov/news.release/pdf/cpi.pdf
4. https://www.goldmansachs.com/insights/pages/stress-among-small-banks-is-likely-to-slow-the-us-economy.html
5. https://rejournals.com/nothing-normal-about-todays-market-higher-rates-put-brakes-on-multifamily-finance-requests/)
6. https://www.greystone.com/insights/wave-of-multifamily-debt-maturities-expected/)