Banking Credit Risk Spreads Across Multifamily Real Estate

Comptroller of Currency Highlights Growing Regulatory Concern

Overbuilding of luxury multifamily properties in Nashville, Tennessee, is among the loan risks cited by a federal banking regulator. (Getty Images)

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CoStar News

June 24, 2024 | 4:16 P.M.

High borrowing rates and related costs are putting significant stress on multifamily property, a sign of credit risk in commercial real estate that a financial regulator said poses an increasing threat to the overall health of the federal banking system.

The Office of the Comptroller of the Currency is focusing on the increased risk in the U.S. apartment market, while it added in a report that the office market remains a major concern.

“Rising interest rates, insurance costs, and other expenses are resulting in increased operating costs for many multifamily property owners,” the OCC reported. “However, other risk drivers can vary by market, property type, and other factors.”

The report provides a look at how higher interest rates that have been held in place through the first half of 2024 to combat persistent inflation are affecting commercial property loans extended by banks.

The fallout on multifamily financial risk represents a significant shift from the December 2023 report, where multifamily was mentioned just six times, mainly concerning higher vacancy rates. In contrast, the current report mentions multifamily risks 12 times.

The regulator noted that rent-controlled areas such as New York City and California face potentially greater net operating income compression because of a limited ability to offset rising costs.

The report also identifies the overbuilding of luxury properties in some areas, including Salt Lake City and Nashville, Tennessee, leading to further devaluation of older properties.

Office Concerns Fail To Ease

While multifamily risks have been expanding the most over the year so far, office properties remain the commercial real estate type of most concern to banks, garnering 18 mentions in the report.

“The imbalance between demand and supply has weighed on office sector rent and net operating income growth,” the OCC reported. “Investors continue to pull back from the sector, causing the national average office property price to drop by about 13% from its late 2021 peak, with an additional 15% decline expected by year-end 2025."

It added that "Office properties in urban business districts have experienced the most deterioration in fundamentals, but market stress spread to suburban locations over the

past year."

The OCC classifies these growing risks from office and multifamily deterioration as "moderate," but acknowledges additional risks posed by loans nearing maturity.

"Office and multifamily loans, particularly those with interest-only terms, set to refinance over the next three years pose additional risk," the OCC said.

Commercial real estate "borrowers seeking to refinance maturing loans may need to re-margin through cash equity injections or by providing additional collateral due to higher debt costs and lower property values."

While other commercial property types remain generally sound, they show signs of softening. Retail properties have stabilized overall, but regional malls and stores reliant on in-office workers continue to struggle.

Industrial warehouse vacancy rates, though still relatively low, have risen from historic lows in 2022 and are expected to settle at a slightly higher rate.

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