

COMMERCIAL REAL ESTATE

As storms strike, insurance costs soar

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Postpandemic vacancies and surging debt payments have eaten away at commercial real estate for more than two years. Even as those threats start to fade, owners of strip malls, apartment buildings and office towers face a problem that could last much longer: soaring insurance costs.

The problem is familiar to homeowners across the country. The rise in climate-related natural disasters has insurance companies pushing rates substantially higher, or pulling out of markets.

The rate increases have been fastest in coastal cities and towns vulnerable to damage from big storms or coastal floods, but insurers and banks are coming to terms with the notion that no area is truly safe from increasingly extreme and unpredictable weather events.

Hurricane Helene, which hit Florida's Gulf Coast before leaving a trail of deadly floods and landslides through Georgia and the western parts of the Carolinas, most likely caused at least \$35 billion in economic losses along the way, according to an estimate by reinsurance broker Gallagher Re.

Building owners are also trapped between their insurers and lenders, who are afraid of being on the hook for catastrophic damage and won't allow the smallest changes to policies — even those that might give a struggling borrower some breathing room. *

It isn't possible to know comprehensively how many properties have gone into foreclosure solely because of insurance costs, but people in the industry say they know of deals that have fallen apart over the matter. Developers and investors say that in an industry grappling with higher interest rates and materials and labor expenses, insurance costs can tip the scales.

"This current interest-rate environment has exposed the people that know what they're doing and those that don't," said Mario Kilifarski, head of asset management at Fundamental Advisors, a New York-based investor with \$3.5 billion in assets.

Insurance brokerage Marsh McLennan estimated that premiums on commercial properties rose an average of 11% across the country last year but as much as 50% in storm-vulnerable places like the Gulf Coast and California.

This year, premiums may have doubled in some of those places, the brokerage said. For apartment buildings, insurance costs now account for 8% of operating expenses, twice what they did about five years ago, said Paul Fiorilla, director of research at Yardi Matrix, a data provider. Compared with expenses like taxes and maintenance, insurance is still a small sliver of the pie, Fiorilla said, but it is adding to the strain caused by stagnating rents and higher borrowing costs. Landlords' operating expenses grew faster last year than their income, he said.

Lenders are worried. *

"We're constantly hearing from our banks," said Kevin Kaseff, a co-founder and the managing partner of Titan Real Estate Investment Group, a California-based owner of living facilities for seniors and cold-storage buildings for fruits and vegetables bound for supermarkets.

The lenders have been asking for details about how he is getting insurance, Kaseff said, particularly on buildings in California, where some insurers have stopped doing new business.

"They're nervous," he said, adding that it was frustrating that although the lenders seemed eager to hear about his latest plans, they expressed no willingness to help.

Like homeowners, commercial property owners are required by banks to carry insurance policies if they have a mortgage. But the requirements can be stricter: A commercial real estate borrower often needs explicit permission from its lender to make tweaks to insurance coverage, and if the loan has been securitized and sold to Wall Street investors, getting that permission can be impossible.

Lenders have largely refused to soften insurance requirements because they worry about the potential impact on the broader property market. If a big disaster destroys a building, what happens if no one can afford to rebuild it?

"Insurance pricing has caused deals to come to a halt and has forced deals into foreclosure in some cases," said Danielle Lombardo, chair of the real estate, hospitality and leisure division at Willis Towers Watson, an insurance brokerage. Part of the problem, she said, is that costs can jump from the time a buyer begins putting together financing to the moment the deal is about to close.

To Kaseff, the solution seems simple. Banks should let commercial real estate owners buy insurance with higher deductibles to reduce the cost of coverage. Or they should approve of policies covering only the value of the bank loan instead of the cost of replacing the building if it is destroyed. *

But banks may be unwilling to budge, because if landlords without full insurance coverage cannot rebuild after a big disaster, it could destabilize the real estate market, hurting the value of banks' collateral, said Adam DeSanctis, a spokesperson for the Mortgage Bankers Association, a trade group. Regulators, too, are watching how the banks respond so they don't increase risks to the financial system.

Analysts say the insurance problem is more of a headache than a potential catastrophe, and data on loan delinquencies shows stress but no cause for major alarm. By being extremely cautious about their lending and shedding as many older commercial real estate loans from their books as they can, banks may have staved off a crisis.

Since fall 2022, delinquencies have risen to 1.5% of all outstanding commercial real estate loans, said Nathan Stovall, director of financial institutions research at S&P Global Market Intelligence. The largest banks are reporting the biggest jump in delinquencies — a 5% rate. That's still far from the 10% during the 2008 global financial crisis.

The commercial real estate slump is hitting bigger banks harder because their lending involves the buildings — like skyscrapers in urban areas where office workers have not returned — most affected by changes in occupancy patterns that began in the pandemic, Stovall said.

On Sept. 18, the Federal Reserve cut its benchmark interest rate by half a percentage point, the first cut since rates rapidly climbed in 2022 and 2023, and it is expected to cut further this year and next.

This is the first piece of good news for commercial real estate owners in years, but it doesn't mean the developers are out of the woods. Interest rates are still much higher than they were the last time many borrowers took out loans on their properties (many did so during the rock-bottom rates caused by the pandemic). And new loans are hard to find.

Both DeSanctis, the banking industry representative, and Lombardo, the insurance broker, said dealing with insurance coverage was once a task left to middle managers, who never bothered top executives with the details. But that has changed.

A small, yearly conference hosted by DeSanctis' trade group that once attracted only about 100 people strictly bearing the title of "risk manager" has doubled in size to address the increasingly high-stakes pursuit of property insurance, he said. It is now a broader strategy conference, attended by people who make lending decisions or serve in senior management.

Mortgage bankers need to consider risks that used to seem too remote to worry about, DeSanctis said, especially in light of the destruction that Hurricane Helene caused far from the coast.

"It is an additional thing to analyze," he said.

