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CRE Research

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Increased Capital Competes for Multifamily Investment, Underwriting Relaxes

Capital Flows to Multifamily Market

As more capital flows into US commercial real estate and lending competition grows, many industry experts are pointing out loosening underwriting practices. While underwriting tightened during the Great Recession, market indicators suggest that the rebound of the economy has prompted lenders to take on more risk.

According to an annual survey about credit underwriting practices conducted by the OCC, over half of the national banks polled tightened standards for commercial products from 2008 to 2010. In 2009, 86% tightened practices. Since 2011, a rising percentage of surveyed banks have loosened their standards, while fewer banks have tightened underwriting.

Commercial real estate products are cited as a major contributor to this trend. OCC data shows that 34% of surveyed banks eased commercial credit underwriting in 2014, while only 5% tightened standards.

In their *Semiannual Risk Perspective* for Spring 2015, the OCC attributed increased risk tolerance to the strengthening competitive atmosphere, persistent low interest rates, and pressure to deploy capital. The report concluded that "bankers continue to express concerns about the effects that intensified competition with other regulated financial institutions and nonbank financial firms are having on underwriting standards."

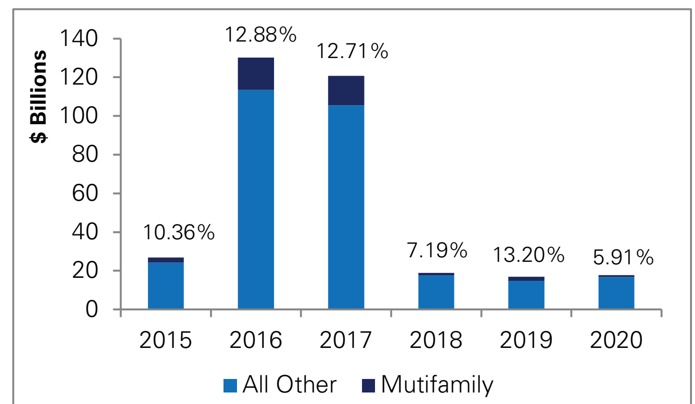
Many wondered if FHFA's $30 billion annual production cap on lending for GSEs would affect growth in the non-agency multifamily CMBS market. After speculation that the quota would be reached by end of the third quarter, Fannie Mae and Freddie Mac responded by tightening underwriting standards and hiking interest rates to reduce the flow of lending.

The FHFA later relaxed its criteria and widened the list of affordable housing loans exempted from the capped volume. Despite the exemptions and continued new agency issuance, CMBS lending has showed no signs of slowing, as total 2015 multifamily volume is steadily approaching last year's levels.

According to the Urban Institute, the market share of agency multifamily originations has declined back to early-2000 levels with the reemergence of private capital, from 70% in 2008-2009 to just over 30% in 2014.

Non-agency CMBS originations for multifamily properties nearly doubled between 2013 and 2014, with 2014 volume reaching $10.8 billion. Conduit loans

Figure 1. All Non-Agency US CMBS Issuance



are the main source of non-agency financing for multifamily properties, with 2015 year-to-date issuance volume of $7.4 billion through October.

Looking at the credit characteristics of these new conduit multifamily loans illustrates a theme of slowly loosening credit standards.

Higher LTVs, Lower Cap Rates

When credit standards relax, average LTVs normally rise. Historically, average LTVs have been higher for multifamily vintages than loans of other property types. Higher LTVs indicate that borrowers are financing a larger portion of their properties through mortgages. While the upward trend in multifamily LTVs is not as pronounced for other property types, multifamily leverage has still shown a slight increase since 2011-2012 levels.

Current average LTVs on new multifamily loans are back at pre-crisis levels, around 70% LTV compared with low 60s during the first years of the recovery. Cap rates, which measure a property's operating income relative to its appraised value, have also fallen in the past five quarters. Average cap rates have dropped from 6.78% a year ago to 6.28% for the most recent quarter.

Interest-Only Structure On the Rise

The increasing use of interest-only loan structures is yet another indicator of a competitive lending market and consequential credit loosening. Full interest-only loans are deemed riskier than loans that require principal payments, as borrowers postpone principal payments until maturity and therefore have less equity at stake if the property runs into trouble.

Figure 2. Non-Agency Multifamily CMBS Issuance

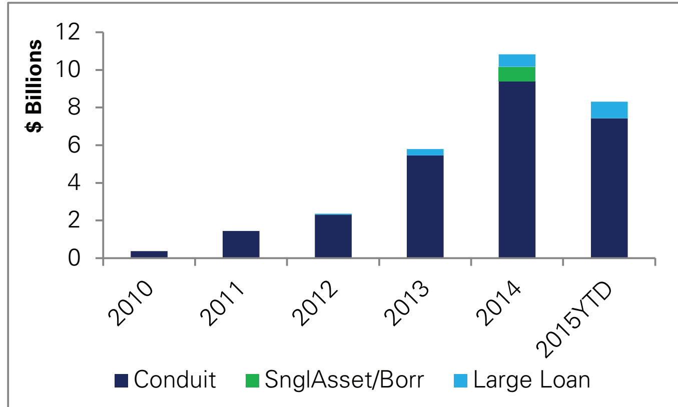


Figure 3. New Multifamily Issuance by Amortization Type

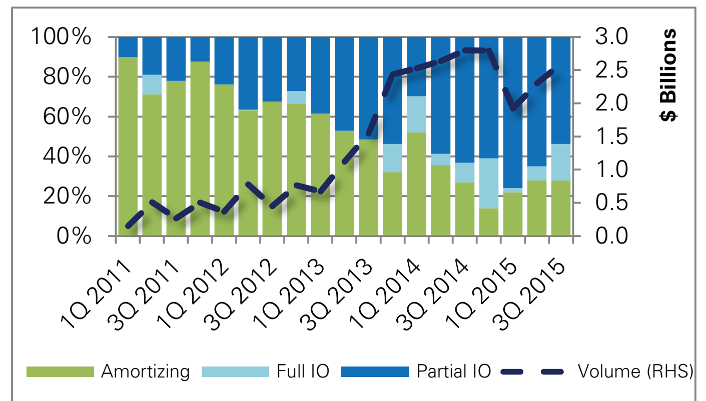


Figure 4. Conduit Multifamily LTV & Cap Rates

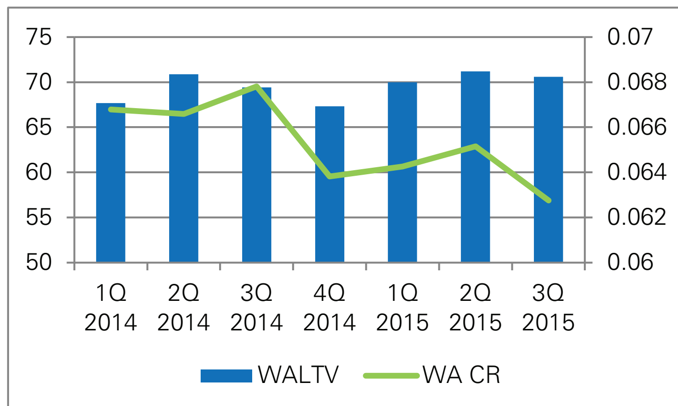
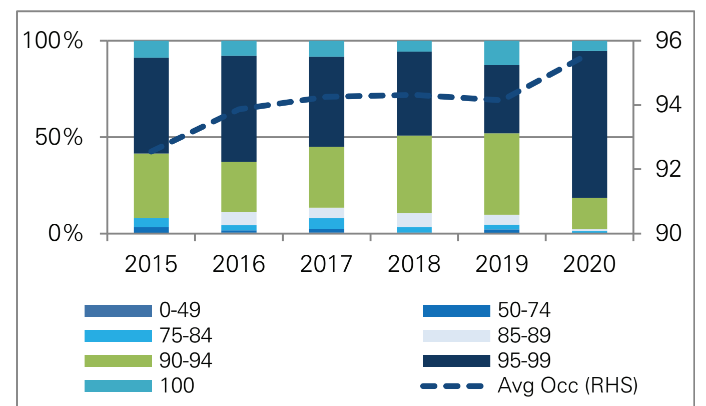
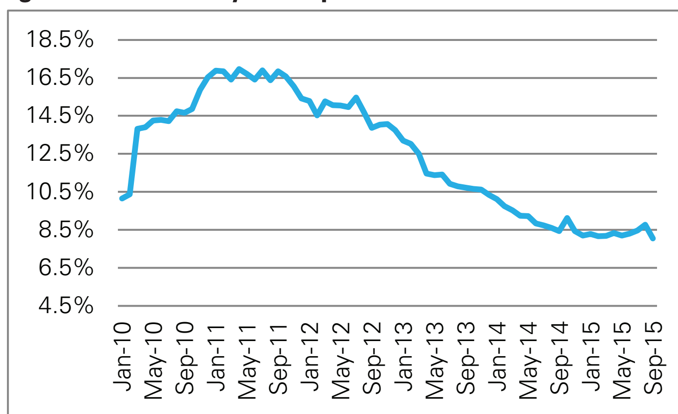


Figure 5. Maturing Multifamily Occupancy Rates



Interest-only structures also carry higher refinancing risk on the part of the lender. The proportion of interest-only loans in new multifamily issuance has grown substantially in the last five years, from 19.76% in 2011 to 56.10% in 2013. In this case, interest-only includes full term IO and partial term IO loans. For the first three quarters of 2015, interest-only loans encompassed a substantial 73.75% of all loan types.

Figure 6. Multifamily Delinquencies



Multifamily Performance

Multifamily delinquencies have fallen drastically during the recovery. The delinquency rate for multifamily loans peaked in early 2011 at 16.97% and remained elevated until early 2012. The rate has consistently improved since then, dropping to 8.17% as of October 2015.

Because the massive $3 billion Stuyvesant Town/Peter Cooper Village Complex loan comprises the bulk of multifamily delinquent volume, the impending sale of the property should bring the delinquency rate below 3.5%. The total delinquent balance for multifamily loans should drop to around $1.5 billion when the sale occurs.

Looking Ahead

For the last quarter of the year, $2.8 billion worth of non-agency multifamily CMBS loans will be subject to refinancing upon maturity. In light of the impending wall of maturities, an additional $32.1 billion will mature in 2016 and 2017, constituting 12.8% of the total balance of maturing CMBS loans.

Due to strong multifamily housing demand, occupancy levels are high for loans maturing in the next five years. More than 85% of reported loans maturing through 2020 currently hold occupancy levels greater than 90%. Less than 10% of those loans have occupancies below 50%. The property type's generally strong occupancy and financial performance, coupled with the large maturing multifamily balance in the next two years, will serve as a pipeline for further multifamily CMBS issuance growth in the coming years. ■

For inquiries about the data analysis conducted in this research, contact press@trepp.com or call 212-754-1010.
For more information about Trepp's commercial real estate data, contact info@trepp.com.

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