# Against the storm: Lenders taking strong stance on natural disaster risks

As insurance costs rise, the commercial real estate market is assessing the impact of natural disasters on a local and asset-specific basis.

By Shihao Feng

Commercial real estate lenders are taking increasingly strong measures against the potential impact of climate change and other natural disasters such as flooding, wildfires, and unpredictable weather patterns.

For loans on assets in regions that are more risk-prone, lenders are scrutinizing properties' resilience and insurance coverage more stringently during the underwriting process. Borrowers are also pursuing ways to increase resilience and secure the value of their assets against potential natural disasters.

Peter Gordon, chief investment officer and head of the US commercial real estate debt team at AllianceBernstein, says the Nashville-based manager is very focused on the potential impact of natural disasters such as earthquakes, hurricanes, fires, storms and violent tornadoes. "We would not lend on a property unless we were properly insured for those risks," he says.

"There might be situations where we think the risk is just too high even if you are insured, and therefore, we wouldn't lend there."

As part of its due diligence process, AllianceBernstein is completing ESG evaluations to score property locations in case the environmental risks are too high for lending. "There might be some situations where we think the risk is just too high even if you are insured, and therefore, we wouldn't lend there," Gordon says.

The sentiment is increasingly common among commercial real estate lenders. Peter Cerrato, a managing director for US Real Estate at Charlotte-based manager Barings, noted the long-term implications of climate risk issues may result in higher costs of insurance and remedies, thus diminishing the property's value in the future.

"Over time, properties in certain geographic locations may not be insurable, and that could be a concern for the next person. We have to look through that lens, even though it might be 10 years or more out in the future. It's part of our due diligence process including insurers' available capacity in certain states," Cerrato says.

Similarly, borrowers operating in climate risks-prone regions are trying to secure the value of their properties over the long term by insurance – or by simply constructing more resilient buildings at the outset.

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**Borrower view**

Shoreham Capital, a West Palm Beach-based real estate developer and manager, aims to construct properties that satisfy or even surpass the local building codes in terms of resiliency against possible natural disasters.

Doug Faron, founder and managing partner of Shoreham Capital, says the company does so to gain more favorable insurance rates in the short term. For the longer term, adhering to building codes helps the firm to build products that last longer, are more resilient, and less expensive to operate.

The company tends to build cement block constructions, which score better in Florida's building codes requirements. These requirements include wind rating of roofs and the resilience against wind weight on property structures.

"There are parts of Florida where you can build stick rather than cement block, but we prefer to build [cement] block construction in the projects we do because we are focused around building a resilient product in light of greater storm risk in the current environment," Faron adds.

Faron believes the current building codes are a reliable and effective guideline for developers to optimize their properties' resiliency.

"If you do build to the stringent current building code, you can create a resilient product that doesn't have some of the risk factors that older product does," Faron says. He cites Hurricane Ian, which raked a path of destruction in Florida in 2022. "If you look at the damage that was created in Cape Coral and Fort Myers, a lot of the damage that occurred was to aging structures that weren't built to current building codes."

For borrowers, a significant challenge is finding proper insurance coverage for their assets. Insurance costs have been rising due to surging replacement costs pushed up by inflation and an increased propensity of natural disasters in general.

Faron noted Shoreham Capital has seen a significant insurance cost increase per unit for its multifamily properties, which adds financing pressure on new constructions.

"Between the rising cost of capital and insurance in Florida, there's a real challenge to building product. You have to go through way more opportunities to find ones that work with these new constraints," he adds.

**CMBS stance**

The rating agencies that are looking at commercial mortgage-backed securities deals are also taking a serious view of potential environmental risks.

Fitch Ratings, a New York-based rating agency, will not be able to rate commercial real estate loan transactions if the insurance of the underlying properties is not sufficient or does not meet its criteria, according to Eric Rosenfeld, a managing director.

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"What we do for all transactions is [to] review the insurance structure, and [that is] also relative to what we consider to be the risk profile for a particular asset, and its location," Rosenfeld says. The agency is looking for the coverage of a full replacement cost of the asset in risk insurance, he adds.

The uncontrollable factor, however, is that no one knows when and the extent to which a potential natural disaster can cause to a property in the future.

AllianceBernstein's Gordon says that compared with short-term lending, longer-term underwriting requires more acute consideration in evaluating climate risks. Given these concerns, this may push some mainstream lenders to the sidelines for certain risks.

"If you are at all concerned that your loan is not covered by the insurable value, you're not going to take that risk.

Calculating that probability and magnitude of risk is difficult and not an exact science" he says.