Eco-Consciousness Is Within Reach

Fannie and Freddie are making environmentally friendly loans attractive

By Igor Zhizhin

The combination of higher interest rates, compressed cap rates and increased operating costs have forced many players in the commercial real estate sector to search for alternatives to save on financing costs, whether they are already property owners or are looking to acquire real estate. The borrower-friendly green initiatives offered by the government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae have created an opportunity to do just that while also promoting more environmentally efficient multifamily buildings.

Importantly, the current incentives offered by the GSEs greatly reduce the costs of qualifying for their green financing. Simply put, in the current lending environment, there is no significant reason not to consider these GSE initiatives. Commercial mortgage brokers looking to close more deals should have Fannie's and Freddie's green-financing programs on their radar, and ensure they are up to speed on the advantages they offer to qualified borrowers.

Fannie and Freddie have been actively marketing their environmentally friendly financing programs for several years. Collectively, the GSEs each year provide billions of dollars in green financing, primarily through Fannie Mae's Green Rewards and Freddie Mac's Green Advantage programs.

The major requirement for qualifying for the programs is the ability of a property owner to reduce water or energy utilization by at least 25 percent. The current motivation for the agency lenders to incentivize mortgage brokers and their clients to use these programs is the fact that green-financing loans don't count toward the GSEs' annual loan caps. That feature allows the GSEs to provide added liquidity in high-demand areas and also supports market-share growth in the green-financing arena.

Streamlined process

The qualifying process for borrowers seeking GSE-backed green loans has become much more streamlined, cost-effective and transparent. The first step is to order an energy and water audit, in the case of Fannie Mae, or a green assessment, in the case of Freddie Mac, to identify potential opportunities for energy and water savings.

With both Freddie Mac and Fannie Mae, these reports are fully refundable if the loan closes, increasing the incentive for most borrowers to proceed. One of the critical factors to help expedite the completion of the report is ensuring active participation by tenants to provide their water and electricity bills. Traditional examples of eligible repairs or upgrades include heating, ventilation and air conditioning (HVAC) improvements; replacing aerators and toilets; and installing energy-efficient appliances.

Should the findings of the green assessment or audit support the required level of energy or water savings, the borrower is given the opportunity to proceed with either a Green Rewards or Green Advantage loan. The chance of not being approved is slim. The fundamental challenge the borrower will face is balancing the costs of making the required improvements against the loan-structure benefits.

Program perks

The available benefits are appealing and materially different from traditional loans. First, Freddie Mac offers an interest-rate discount of 15 to 30 basis points, while Fannie Mae offers a reduction of up to 35 basis points. Second, Fannie and Freddie offer an additional 5 percent leverage, and Freddie's Green Advantage program allows a 0.05 percent reduction in the debt-service-coverage ratio (DSCR) floor. There also is additional weight put on the property's as-improved net operating income and appraisal value.

The requirements to remain compliant are not overly demanding, but do include a more extensive level of reporting and capital investment. Although it fluctuates greatly, borrowers who have not already completed green certifications in the past should assume the repair work will cost at least $300 per unit. An investment of more than $500 per unit is a more likely, however, in the event of a voluntary decision to pursue a more robust energy-savings project.

It also should be noted that even though leverage is increased through the GSEs' green-financing programs, approved improvement plans are required to be escrowed at loan closing. Freddie Mac requires 125 percent of the improvement amount escrowed, while Fannie Mae requires 100 percent. Borrowers also are required to deliver regular reports on water and energy use throughout the period recommended by the audit or assessment, in order to meet the efficiency requirements.

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Bottom-line positive

If the improvements require tenant involvement, it is important to ensure tenants will cooperate with timely monthly deliveries of utility statements. If a property owner feels this will be challenge and appropriate cooperation isn't likely to occur, it is best to eliminate tenant involvement and focus strictly on common-area requirements.

The actual approval of proposed improvements is a streamlined process. Borrowers must deliver copies of paid receipts, images of the installed work, and copies of completed permits and approved architectural renderings, if applicable. Freddie Mac allows 24 months to complete the required work; Fannie Mae provides 12 months.

The considerable benefits of these GSE green-loan programs, compared to the relatively limited financial and operational requirements, makes them ideal for almost every borrower profile. The perfect profile is a borrower who has already committed to making property improvements with an energy-efficient component. Both GSE programs strongly reward work that would have been undertaken regardless.

The majority of the building-improvement requirements are reasonable and quite manageable. It also is typical to have between 15 to 20 different energy-saving options to pursue under the programs, giving a borrower ample flexibility to identify improvements that are cost- and labor-effective. The work also has the double advantage of increasing the profile of the property by allowing owners to promote its environmentally conscious management while, at the same time, reducing operating expenses in the long term to directly increase the property's net operating income.

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In the current lending environment, in which rates continue to increase and there is a general consensus among most commercial banks to take a more conservative approach to high-leverage deals, there is no strong argument against applying for the GSEs' Green Rewards or Green Advantage programs. If these programs retain their current structures and requirements, it's a good bet they will eventually transition from being obscure loan options and into programs that are in high demand by a far greater number of commercial mortgage brokers, as well as the clients they serve. Why not get ahead of the pack? ■