
Removing Impediments to Energy Efficiency from Mortgage Underwriting and Appraisal Policy

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Goal: Enable the market to internalize the financial impacts of energy efficiency by reforming standard residential underwriting and appraisal practices

Addressing the Appraisal Problem

Property appraisal is an essential part of the mortgage underwriting process for residential buildings. Conducted by a licensed professional, an appraisal yields an estimate of market value, which the automatic underwriting system (AUS) then uses to help determine how much to lend. Appraisals using standard forms are required by the major purchasers and guarantors of mortgages in the United States, including Fannie Mae and Freddie Mac. These institutions set the rules and create and maintain the forms and AUSs.

In determining value, residential appraisers rely almost exclusively on comparisons with similar properties recently sold in the area. Value can also be determined by considering cash flows associated with owning and occupying the building, including operating costs. Under this method, energy efficiency should in theory be recognized as a factor enhancing value. In reality, however, residential appraisers rarely take account of reduced energy costs, for lack of time, tools, resources, expertise and incentive. The appraisers' clients, including residential lenders, are also largely indifferent and uninformed about energy efficiency.

The residential mortgage market has been beset by rampant defaults in recent years, leaving our entire economy in crisis, with taxpayers on the hook for most failed mortgage loans. It has become clear that to protect taxpayers' interests, the federal government must fix underwriting and appraisal policies to take more accurate account of property values and borrowers' capacity to service debt. Energy efficiency is an important part of this picture of sound lending. **(Mortgages on ENERGY STAR homes have an 11% lower default and delinquency rate than do comparable mortgages on other homes.¹)**

Fannie Mae's current Energy Efficient Mortgage (EEM) theoretically addresses the appraisal problem by adding the net present value (NPV) of energy savings to the appraised value of the home. Unfortunately, **throughout the many years since EEMs' introduction, an insignificant number of EEMs have ever been written.** Until 2007, EEMs provided little actual value because appraisers almost always "hit the number" and most people could qualify for more mortgage than they could afford. It wasn't worth lenders trouble to apply for EEMs. The market has now concluded that EEMs are irrelevant and many will be inclined to ignore any incremental changes to EEMs. One solution is to fix standard appraisal and underwriting practices to properly consider energy efficiency and then eliminate "EEMs" entirely.

Some outwardly modest but fundamental changes to the standard process of appraisal would start with energy-related additions to the Uniform Residential Appraisal Report (URAR), the standard Fannie Mae form used for residential appraisal. (Other agencies also stipulate the use of this form, or similar ones.) The URAR and similar forms should be expanded to include a box noting whether the appraised value has been adjusted to account for energy efficiency. Appraisers who check the box would then also append a HERS report, similar documentation or explanation, as appropriate.

¹ A statistically significant correlation with a 99% confidence interval (2009 analysis).

Initially, many appraisers will not learn about HERS reports or take the time to check the box and append a HERS report. In these cases, the mortgage originator would be empowered to enter into the AUS the NPV of projected energy savings from a HERS report, which would be included in the case binder for the mortgage.² The AUS would add the NPV to the appraised value of the home for the purpose of evaluating the mortgage and down payment. (NPV of projected energy savings would appear prominently on the front page of HERS reports.)

This proposal recognizes the reality and enormous inertia of the appraisal industry without undermining the appraiser. It would dispel any fears that efficiency would be double counted. This relatively simple advance would enhance the asset-value incentive for owners/sellers to implement and document energy efficiency in homes, without creating major changes in appraisal practice.

Fixing Underwriting for All Mortgages

Mortgage underwriting generally considers three major areas in determining whether a loan will be issued, and at what size – the value of the collateral, the borrower’s cash flow, and the borrower’s credit history. Appraisal deals with the first area, with energy playing an important role as discussed above. Energy efficiency also directly affects the second area, the borrower’s cash flow, by reducing operating costs. Documentation of reduced energy costs via energy efficiency can and should be taken into account by lenders as they assess the borrower’s cash flow and ability to service debt. Lenders already routinely do this deeper underwriting during the loan modification process, but despite the foreclosure crisis lenders still fail to do so at mortgage origination. By contrast, household costs smaller than energy costs (like insurance) are fully considered in mortgage origination.

The solution is to fully factor energy costs into underwriting for **all** mortgages. **This solution would not require an energy rating for every mortgage.** Instead a default per-square-foot energy cost would be assumed for all homes that do not have energy ratings. The default energy cost could be based on the Residential Energy Consumption Survey (RECS) or analogous local sources where available.

The above underwriting changes would require adjustments to standard underwriting ratios, automated underwriting systems³ and energy rating software as well as limited training for energy raters. The energy raters would in turn walk lenders through the learning curve of attaching HERS reports to mortgage applications. Other EEM paperwork and administrative hurdles would be eliminated. Earned media through *Recovery Through Retrofit* could tap into significant latent consumer interest.

The Bottom Line

These proposals would save energy and create jobs by removing finance impediments and increasing demand for energy efficient retrofits, energy-efficient new construction and energy ratings. They are fully compatible with PACE financing, credit enhancements and other efficiency initiatives. These proposals appeal to many important stakeholders, including construction workers, job seekers, home buyers, retrofit providers, manufacturers of efficient products and home builders (whose bottom lines are now being hurt by appraisal problems).

² During the first year, a small extra payment to the mortgage originator for taking the extra minute to append a HERS report would be extremely cost-effective in hastening uptake.

³ These adjustments could be calibrated to insure that the primary impact is to make it easier to qualify mortgages on efficient homes. The result would be elegant, self-consistent and based on data and sound economic/credit policy.