Green CMBS

Pooling green building mortgages into securities and showcasing their value in the financial market may be the next big step for green buildings

In 1994, the commercial mortgage-backed securities market was a $50 billion industry. Today, the Commercial Mortgage Securities Association estimates the market at $500 billion, making up 25 to 30 percent of the mortgage market.

This growing secondary market for commercial mortgages provides both liquidity and diversification for large commercial real estate investors, including insurance companies and large pension funds. The scale of that market is the reason that the Institute for Market Transformation to Sustainability (MTS) is promoting development mortgage-backed securities for green buildings.

"In 1995, mortgage-backed securities pools were created for buildings completing Phase 1 environmental site assessments (ESAs), complying with the ASTM Phase I national standard to avoid cleanup liability," says Michael L. Italiano, president and CEO of MTS. "These securities provided much higher value and lower risk to investors, and were rated higher by Standard & Poor's, allowing greater profit margins for investment bankers. Phase I ESA-MBS achieved 95 percent market penetration of all commercial buildings in five years."

Those statistics lead Italiano and other members of MTS to believe that green mortgage-backed securities could potentially provide the same benefits for the green building market over the next five years. "We project that green MBS would take green building market penetration to 70 percent, add $1 trillion a year to the U.S. economy and go a long way to meet U.S. Kyoto mandates," Italiano says.

Mortgage-backed securities

Commercial mortgage-backed securities are similar to traditional mortgage-backed securities, which are mortgage loans backed by residential loans and offered by such organizations as Fannie Mae, Ginnie Mae and Freddie Mac. However, they also are different because commercial mortgages are more complex and less standardized than residential mortgages.

In residential mortgage-backed securities, the investor buys part of a large pool of similar residential mortgages. In commercial mortgage-backed securities offerings, the number of loans in the pool is smaller and often the pool is segregated into sequential pay bonds, called tranches. The highest-rated tranche generally carries a AAA rating and is paid off first. The next tranche will have a lower rating and be paid off next, and so on, until all tranches are retired. The bonds are rated by Duff & Phelps, Fitch, Moody and Standard and Poor's.

Green buildings are attractive because they have HIGHER VALUE, LOWER OPERATING COSTS, increased tenant retention and greater access to capital

"Based on our discussions with rating agencies and our past experience, the rating agencies would provide green commercial mortgage-backed securities or bond them at a higher rating because green buildings perform better financially than conventional buildings," says Italiano.

Importance of debt-service-coverage ratio

Because lenders are looking at the collateral, not the borrower, property cash flows and values become very important. According to mortgage brokers, two important indicators of loan credit quality are the debt-service-coverage ratio and the loan-to-value ratio. The debt-service-coverage ratio is the income that a property generates divided by the costs associated with running it. For more favorable property types, a debt-service-coverage ratio of 1.3:1 to 1.5:1 is acceptable to Vanderbilt Capital Advisors, for example. Properties generally considered good performers are office buildings and hotels in major cities, large high-end shopping malls and anchored strip malls. Multifamily buildings also are considered favorably. For less favorable property, Vanderbilt requires debt-service-coverage ratios nearing 2.0. Suburban office space and hotels, mid-level malls and unanchored retail centers often are considered less favorable collateral by investment bankers.

Because the debt-service ratio is critical and because green buildings operate more efficiently than their non-green counterparts, Italiano sees great promise in green commercial mortgage-backed securities.

"The buildings whose mortgages are in green commercial mortgage-backed securities pools have higher value from lower building operating costs, greater occupant satisfaction, increased value and tenant retention, and greater access to capital," says Italiano. "For example, for its green building headquarters, National Geographic increased its appraised value, received a higher Moody's credit rating, increased tenant rents, lowered interest rates on loans secured by the realty and enjoyed reduced worker absenteeism."

Proving benefits

Public green commercial mortgage-backed securities auctions are expected to attract large institutional funds. Scott Muldavin, president of the Muldavin Co., says green commercial mortgage-backed securities will be offered by investment bankers once the investment bankers realize the value of green buildings. State government pension funds, a group that invests heavily in real estate, are one promising market for green commercial mortgage-backed securities.

"Pension funds are significant investors and they build a lot of buildings," says Muldavin. He should know. The Muldavin Co. developed the risk-rating system for Standard and Poor's that initiated the $400 billion commercial mortgage-backed securities industry.

"We have had several MTS committee meetings with mortgage-backed securities purchasers and other supporters, and talked with rating agencies and investment bankers, who manage hundreds of billions of dollars of commercial mortgage-backed securities investments," says Italiano. "Based on past green mortgage-backed securities pools, they are interested in green commercial mortgage-backed securities and believe that green building pools would receive a higher rating for investors due to some existing corporate guarantees of green building cost savings for 30 years."

MTS also is speaking with Fannie Mae executives to learn their interest in green MBS for multifamily residential property mortgages. Fannie Mae is the nation's largest source of financing for home mortgages. Fannie Mae CEO Franklin Raines has said Fannie Mae operates two businesses. It has a portfolio business, which buys mortgages

LEED as benchmark for financial marketplace

To qualify for the green mortgage-backed securities pool, buildings would be rated using the U.S. Green Building Council's LEED (Leadership in Energy and Environmental Design) green building rating system. LEED is feature-oriented and awards credits for satisfying specified green building criteria. The five major environmental categories reviewed are sustainable sites, water efficiency, energy and atmosphere, materials and resources, and indoor environmental quality.

The LEED standard has been adopted nationwide by federal agencies, state and local governments and interested private companies as the guideline for sustainable building. One reason for the interest is the growing recognition of the long-term economic value of green buildings. For example, in June, Mayor Richard M. Daley announced that all of Chicago's newly constructed buildings will be LEED certified. He believes that ensuring LEED certification for all new construction and major renovation projects will save taxpayer money by reducing annual operating costs. Daley hopes that with these green building strategies in place for public buildings, the private sector in the Windy City will embrace the concept as well.

LEED commitments are not restricted to Chicago. In fact, there are 1,535 registered LEED projects totaling more than 187 million gross square feet of new construction. These projects are located in 50 states and 12 countries. Of these, 126 projects are certified.

When commercial lenders recognize that green buildings ARE EXCELLENT COLLATERAL, green mortgage-backed securities will be viable

originated by lenders, and it has a credit guarantee business, which helps lenders convert their mortgages into mortgage-backed securities. Both businesses help lenders replenish their funds to lend.

Currently, Fannie Mae does not have a green commercial mortgage-backed securities program. However, it does have an energy efficient mortgage program that can be used for one-unit, single-family, owner-occupied principal residences and condominiums. Why? "After the mortgage payment, the monthly utility bill is usually a family's next largest housing-related expense," says Michelle Desiderio, senior product developer at Fannie Mae.

Homes may be new or existing housing, but must have a home energy rating system report. The money saved in energy costs, as documented by the report, is factored into the mortgage. So, if the certified energy consultant determines that the home will save $1,200 a year in reduced energy use, that amount is considered home-buying power for the consumer. Energy efficient mortgages also encourage the use of utility and manufacturer rebates by allowing these rebates to be applied toward the loan under some programs.

Though commercial mortgages are more complex and less standardized than their residential counterparts, energy-efficient buildings offer their owners similar cash flow advantages, as less capital is laid out each month to pay utility charges.

When commercial lenders recognize that green buildings are excellent collateral, green mortgage-backed securities will be viable. "There's a tangible, quantifiable benefit in green buildings," says Muldavin. "But right now there is a knowledge gap among lenders."

MTS hopes to close that gap in the next year or two by educating investment bankers and others interested in commercial mortgage-backed securities supporters. Once that case is made, Muldavin believes green building mortgages offer "a gigantic opportunity" not only for green commercial mortgage-backed securities, but also for more green buildings. "When lenders value green building mortgages because they realize those buildings have increased property value," he says, "then more owners will be investing in green buildings and green building standards to qualify for those mortgages."

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