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Green Underwriting Standards Proposed

Factors including Energy Star and LEED would result in more favorable financing

By GREG KANE

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A coalition of government, finance and real estate officials from across the country has written a set of underwriting standards it hopes will lower borrowing costs and increase investment in and development of green buildings.

The **Capital Markets Partnership**, a Washington D.C.-based coalition working to improve sustainable investment, released an updated version of its Green Building Underwriting Standards in November. The standards encourage banks to take such factors as the U.S. Department of Energy's Energy Star scores, ratings from the **U.S. Green Building Council's** Leadership in Energy and Environmental Design program, climate neutrality and others into account when considering whether to finance a transaction, said Donald Simon, an Oakland attorney who worked on the project.

Simon, a partner with **Wendel, Rosen, Black & Dean LLP** who also is active with the USGBC, said the standard is designed to encourage lenders to consider the long-term benefits of low water and energy consumption - as well as the desirability in the marketplace for green properties - when analyzing default risks on a transaction. Owners of buildings with lower energy and water bills that have a higher demand for occupancy than traditional counterparts are far more likely to keep up with their mortgage, he said.

Dan Winters, president of Washington D.C.-based real estate investment and advisory firm **Evolution Partners** who also worked closely on writing the standards, said lenders often don't ask important questions related to sustainability when evaluating a transaction. The new green standards would encourage research into Energy Star scores or what elements went into a building's achievement of LEED status.

"It seems like a no-brainer, but no one's asking it," Winters said. "You've got to get deeper. At the end of the day, it's all about risk and it's all about making better risk-adjusted decisions."

The standards assign buildings a score from 25 to 100 based on a formula that includes the Energy Star score and whether it is LEED-certified or produces zero-net energy, officials said. The process also includes a scoring system that examines energy and water consumption and other aspects that go into LEED, but also looks deeper into such elements as indoor air quality, Simon said.

Properties with scores on the higher end of the scale could encourage lenders to offer more favorable financing terms, officials said. The scoring system also is expected to be an indicator to investors on the secondary market who, by reviewing the aggregate scores in commercial mortgage-backed securities, could shift more capital into sustainable real estate, Winters said.

"We're trying to stimulate market forces," he said. "That's either done through government mandates, such as adopting energy-efficiency codes, or with the carrot. That second approach is really what we're trying to facilitate."

Green Capital Needed

The problem so far has been the lack of capital in the market to set the standards loose, observers said.

Officials from the partnership - which is a group of mayors from across the country as well as green building interests, lenders and real estate executives - worked for four years on the standards before first releasing them in June of 2008, said Mike Italiano, founder of both the partnership and the USGBC. The so-called 2.0 revisions were released Nov. 10 to incorporate additional Energy Star components and to eliminate properties scoring less than 25 on the scale from consideration.

Italiano said the market for LEED-certified and other green properties remains relatively strong compared with that of traditional properties. But Simon acknowledges that lenders have yet to test the underwriting standards fully because there have been so few transactions to handle.

"A lot of the efforts to get this rolling have been stymied by the fact that the MBS market has dried up," Simon said. "There really aren't many people to be dealing with, and there really isn't much securitization happening."

The common belief, however, is that when the market does return, green buildings will be better equipped to demand a premium in both sale and lease transactions. That demand comes partly from the monthly energy and water savings from which owners and tenants can benefit, Italiano said. But sustainable properties also are more insulated from obsolescence than traditional properties that might be forced into retrofits to stay competitive.

"Back in the 1940s, when air conditioning came in, you had the same thing," Italiano said.

In California, the risk of obsolescence is particularly high, with greenhouse gas reduction legislation such as Assembly Bill 32 and Senate Bill 375 mandating higher standards than the rest of the nation, Simon said. California commercial property owners also will be required to disclose Energy Star benchmarking data in the coming years to prospective buyers, tenants and lenders because of other new state laws, and Simon believes that legislators will eventually mandate sustainability retrofits in the future.

"What you have is something I call 'regulatory risk,'" Simon said. "At some point in the not-so-distant future there's a strong likelihood there will be retrofit requirements imposed on buildings. And if your building is already efficient, it puts you in the upper echelon of energy efficiency. You're already going to have built-in protection."

Knowing the Score

The scoring formula for the green underwriting standards places the largest chunk in two categories: the building's Energy Star score and its Green Building Underwriting Standard score. The first, from the program run through the U.S. Department of Energy, compiles everything from square footage, location, equipment density and employee hours as well as electricity, natural gas and fuel consumption, tallying all of that information into a score that grades a property's efficiency, officials said.

The second score is based on a system devised by the partnership that is similar to those used when judging whether a building is eligible for LEED certification, Simon said. But in addition to evaluation of HVAC and water systems and other bottom-line numbers, it also focuses on such aspects as whether certified lumber or recycled construction materials were used during the development process and other elements that appeal more to the conscience than the checkbook.

"It deals with both the hard numbers and the softer numbers based on market attractiveness," Simon said. "That has a significant value in the marketplace, as evidenced by the value people place in being in a LEED-certified building. It goes more toward reputation and corporate responsibility."

The two scoring systems comprise 75 percent of the overall score, with climate-neutral certification adding 10 percent and LEED between 2 and 15 percent, depending on whether a property has basic certification or Silver, Gold or Platinum ratings. Lenders and potential investors can use a building's score as an indicator of its long-term value and potential, officials said.

The underwriting standards are expected to have a particularly convincing effect on the CMBS market, where loans are bundled together and sold to investors, Winters said. A comparison of two portfolios in which the aggregate score of properties in one is 20 points higher than the other could convince investors to put their money into the greener collection, tipping the balance of capital toward sustainability and encouraging further

development in the area.

When it comes to banks lending money to businesses and property owners, however, being the more sustainable project does not necessarily mean its default risk is lower, Winters said. Lenders also will take into account such indicators as location, competition and property use in their assessments, and all of those factors will be used to calculate the terms of a loan.

"Just because you're green it doesn't mean you have a good real estate project," Winters said. "It is an important part of the underwriting, but it does not change the underwriting in and of itself."

Italiano said that the green underwriting standard will allow Wall Street to discover and, in turn, infuse capital into what he believes is the future of real estate in the United States.

"Green buildings are the only way to go," he said. "The smartest people in the building industry are figuring that out."

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