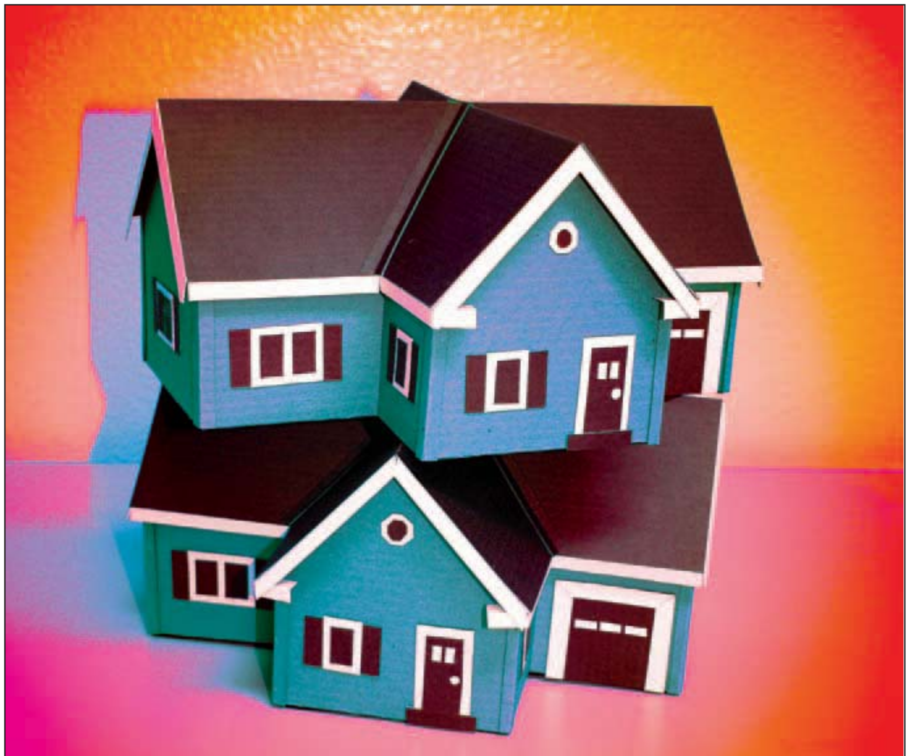
Energy-Efficient Mortgages

The Industry's Best-Kept Home Loan Secret

By Jamie Montague Callister



"We are helping people qualify for more money... because the home is more efficient."
Joel Wiese, Indigo Financial Group

Which would you rather buy: a house with a monthly mortgage payment of $1,000 plus $250 in utilities, or an energy-efficient home with a monthly mortgage payment of $1,100 and only $60 in utilities?

The key to the second option is an energy-efficient mortgage (EEM). "The whole concept is this: if you're saving money on utility costs, that frees up money for additional mortgage," says Bill Fritzsche, owner of EnergyWise Mortgage, Omaha, NE.

An EEM recognizes that energy-efficient homes cost homeowners less to operate. Borrowers who choose such homes can afford to spend more on their mortgage because they will be spending less on utilities. Energy-efficient financing programs allow people to buy a better, more efficient home or easily borrow money to install energy-efficient improvements to an existing home.

While calculating whether a borrower qualifies for a mortgage, a lender recognizes the utility savings and adds the cost of the improvements into the mortgage. If the home is already energy-efficient, the lender can stretch the income-to-debt qualifying ratio, which is expressed as a percentage. (The ratio is calculated by dividing a borrower's monthly payment obligation on long-term debts by the borrower's income.) Even better, the process doesn't take any longer than regular financing.

"We are helping people qualify for more money, but it is used strictly for energy efficiency," says Joel Wiese, Indigo Financial Group, Lansing, MI. "It's okay that you're borrowing more because the home is more efficient."

Home Energy Rating System (HERS)

Once a homeowner has prequalified for a mortgage, the next step is to perform an evaluation of the home's energy efficiency. This typically involves an inspection by a professional energy rater who is certified under a nationally or state-accredited home energy rating system (HERS). The energy inspector will rate the energy-related features of the home (such as insulation, window seals, heating/cooling systems, and air leakage). Following the inspection, the rater provides a report that includes the home's energy rating, as well as an estimation of annual utility use and costs.

The report may suggest ways to improve the home's energy efficiency, the cost of such improvements, and potential annual savings. In every case, the HERS report must indicate that the home is energy-efficient or that recommended improvements will save more money on utilities than they cost to install. Rating scores fall between 1 and 100; higher scores indicate better efficiency. A HERS rating usually costs between $100 and $300, which can be paid by the buyer, seller, lender, or real estate agent. Sometimes the cost of the rating may be financed as part of the mortgage.

"The HERS rating is standard across the U.S. It is an extremely accurate way of certifying efficiency," says Wiese. "It can be a powerful tool if builders know how to use it. Instead of focusing on the cost per square foot of construction, it encourages builders to focus on monthly operating cost."

Energy Improvement Mortgages (EIM)

The term "EEM" broadly applies to mortgages for new, efficient homes, as well as mortgages that include energy-saving retrofits and remodels to existing homes.

When choosing a home, buyers typically max out buying the most house they can afford. Usually there is no extra money left to make improvements," explains Wiese. But if the home is older, it will likely need some energy-efficient improvements, such as a new water heater or furnace. An EIM will allow the prospective buyer to add the cost of the improvements to the price of the house, which is paid through a mortgage. The buyer can borrow more because the energy savings will pay the additional mortgage amount. The best part is there are no additional qualifications, as long as the improvements are cost-effective.

Not all home improvements are cost-effective, such as windows. Energy improvements can be included in a borrower's mortgage only if their total cost is less than the total dollar value of the energy that will be saved during their useful life. However, you can *combine* energy improvements to work together so that they are cost effective. Thus, air sealing and insulation are often coupled with better windows.

Borrowers may also get a larger tax deduction with an EEM because the interest on mortgage payments is tax deductible. This can save more money than paying for energy improvements with a credit card, bank loan, or cash—none of which is usually tax deductible.

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Bill Fritzsche, EnergyWise Mortgage

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Fritszche says the EIM probably has the biggest potential impact on energy savings, simply because about 20% of the real estate market is new construction and 80% is existing homes. Of that 80%, most of those homes could use energy improvements.

Energy-Efficient Financing Programs

EEMs are offered by several mortgage lenders through Fannie Mae, Freddie Mac, the Federal Housing Administration, and the Veterans Administration. The following information is from a U.S. Department of Energy fact sheet available at http://www.eere.energy.gov/consumerinfo/factsheets/feehome.html.

- **Fannie Mae** is a private, shareholder-owned corporation that purchases mortgages from lenders, ensuring that funds are available. The EEM product that Fannie Mae partners offer for existing homes allows the client to borrow up to 15% of the home's appraised value to do improvements. There is no limit imposed on the cost of improvements in new construction. A homebuyer can finance 100% of the improvements without increasing the down payment.

- **Freddie Mac** is a stockholder-owned, congressionally chartered corporation that purchases mortgages from lenders and packages them into securities that are sold to investors. This service provides homeowners with lower housing costs and better access to home financing. With the Freddie Mac version of the EEM product, lenders can exceed the standard 2% debt-to-income stretch at their own discretion. It also allows a broader range of improvements than most EEM programs.

- The **Federal Housing Auth-ority** (FHA) falls under the umbrella of the U.S. Depart-ment of Housing and Urban Development (HUD). The FHA insures mortgage and home improvement loans, in particular for first-time homebuyers and residents of disadvantaged neighborhoods. The FHA's energy-efficient mortgage finances improvement costs of $4,000 or 5% of the property value (up to $8,000), whichever is greater. The FHA maximum mortgage limit for an area may be exceeded by the cost of the improvements. Up to $200 of the HERS evaluation may be included in the mortgage.

- The **U.S. Department of Veterans Affairs** (VA) offers energy-efficient mortgages to veterans with active duty service and qualified reservists. To finance the energy improvements, the loan amount may be increased up to $6,000 if the higher monthly mortgage payment is offset by lower utility expenses. However, a VA refinancing loan cannot exceed 90% of the home's appraised value, plus the cost of the improvements.

- Sponsored by the U.S. Department of Energy and the U.S. Environmental Protection Agency, the **Energy Star Homes Program** encourages builders to construct homes that are 30% more energy efficient than standard code. The program also offers an Energy Star Mortgage through its lending partners. This product combines the features of a conventional or FHA energy-efficient mortgage (offers a minimum 2% stretch on the debt-to-income ratio) and at least one other benefit, such as a lower interest rate, discount on closing costs, free HERS rating, or an extension of the debt-to-income ratio stretch.

Marketing EEMs in Your Business

The only downside to energy-efficient financing is that very few people are doing it. "The EEM is one of most under-utilized programs in U.S.," says Wiese. "Probably because it requires extra steps and asks lenders to know something about energy efficiency."

The best way to get started is to find a lender who is familiar with EEMs. One company, EnergyWise Mortgage, is located in Omaha and closes mortgages nationwide. Their funding comes through Mountain States Mortgage, a lender in Utah that does all of the underwriting. The Indigo Financial Group in Lansing, MI, was the first company in Michigan to close a conventional EEM, and the only Indigo office that offers them. Indigo does financing in 37 states and partners with Countrywide Home Loans, Inc.

To find other such companies, search the Energy Star website for links to program partners. The guidelines were recently changed to be more selective about the companies that are listed. Still, many companies claim to do EEMs, but that doesn't necessarily mean they know how.

You can benefit from energy-efficient financing whether you're buying, selling, refinancing, or remodeling a home. Homebuilders can qualify for a better home because with lower utility expenses, you can afford a slightly larger mortgage payment. Homeowners can obtain financing to improve the efficiency of an older home. A home's superior energy efficiency is an attractive selling point on the market. In an environment of rising interest rates, this selling point may be one way to catch the interest of homebuyers.

From a practical standpoint, the default-rate on EEMs is lower than loans in general. When people are forced to make a choice between paying the mortgage or utility bill, most will pay the heating bill—especially in the wintertime. The EEM helps avoid this dilemma by cutting bills and saving the borrower cash. Also, EEM borrowers understand a little more about mortgage and utility payments. They are much less likely to default on their mortgage.

So far, there is only one problem with energy-efficient financing. In new construction, the addition of energy improvements should raise the appraised value of the home by (at least) the cost of the improvements. So $10,000 in improvements should mean $10,000 more in value. But this doesn't actually happen, in part because there are so few realtors who know how to accurately price energy efficiency. Eco Broker is a market-based performance program teaching seminars for realtors on how to market and sell energy efficient homes. "If you introduce realtors to a way to make more money, they're hooked," laughs Wiese.

Second, the appraisal industry has been slow to catch up with energy efficiency as well. "If you asked the average appraiser to compare an Energy Star home and a regular home, he or she would probably price them equally," says Wiese. EEMs are still relatively "new," so not many borrowers are turning around and selling their homes yet. Lenders are still working to solve these problems in the meantime. But rising energy costs are on their side.

As Benjamin Franklin once said, "A penny saved is a penny earned." That is particularly true with EEMs, where every dollar of energy savings counts as income. Energy-efficient financing programs enable people to buy better, more efficient homes. An EEM allows a prospective buyer to add the cost of the improvements to the appraised price of the house, which is then paid through a mortgage. EEMs may be the industry's best-kept home loan secret. But with a little knowledge about energy efficiency, you can benefit from energy-efficient financing whether you're buying, selling, refinancing, or remodeling a home.

What the EEM Does For A Buyers Borrowing Power

For a standard home without energy improvements:		
Buyer's total monthly income:	$3,000	$5,000
Maximum allowable monthly payment 28% debt-to-income ratio:	$840	$1,400
Maximum mortgage at 90% of appraised home value:	$132,900	$221,500
For an energy-efficient home:		
Buyer's total monthly income:	$3,000	$5,000
Maximum allowable monthly payment 30% debt-to-income ratio:	$900	$1,500
Maximum mortgage at 90% of appraised home value:	$142,400	$237,300
Added Borrowing Power Due to the Energy Efficient Mortgage:	**$9,500**	**$15,800**

Mortgage Rate of 7.5%, Down Payment of 10%, 30 Year Term Principal & Interest Only
Tax & Insurance Not Factored
Source: http://www.pueblo.gsa.gov/cic_text/housing/energy_mort/energy-mortgage.htm

How an EEM Can Save You Money

Borrower finances 100% of energy improvements, (7.25%-30 year term)

	Standard Mortgage	New EEM
Energy Improvement Costs		$3,000
Appraisal Value	$100,000 (add cost of improvement)	$103,000
Down Payment	$10,000	$10,000
Mortgage Amount	$90,000	$93,000
P & I	$614	$634
Monthly Energy Savings	---	$(50)
Total Monthly Payments	$614	$584

Source: DOE fact sheet