

**White Paper of March 24, 2011:
Gas and Oil Leases Impact on Residential Lending**

**** (Please see also Updated and Revised Document of November 15, 2011: **
** Gas and Oil Leases as they Relate to Residential Lending) ****

By Tompkins County Council Of Governments (TCCOG) - Task Force on Gas Drilling
Assessment and Land Valuation Subcommittee
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NOTICE

The information in this presentation relates to the impact of gas and/or oil leases on residential mortgage lending. Consult with a Real Estate Attorney to address specific issues as they relate to a specific property or lease.

No opinion is being expressed or implied on the practice of leasing mineral rights, environmental impact or regulations surrounding gas and/or oil leases (referred to as gas leases or leases hereafter) by the members or presenters of these findings. The issues listed are summarized to highlight potential conflicts for residential mortgage lending in an effort to facilitate consideration of these issues.

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Summary Points

- 1) There is not a cost effective or reliable way to determine if a residential property has a gas lease to allow an Appraiser to establish an appraised value. Title examinations of each property would add significant cost to each transaction in NYS.
- 2) Surface or sub surface rights within 200 feet of a residential structure would not be acceptable for conventional financing in the Secondary market.
- 3) NYS title insurance gas endorsements may specifically compromise or even void title insurance coverage if the premises are used for any commercial venture.
- 4) Lenders are responsible to warrant several items to the investor in the Secondary market that can not be done leaving lenders with significant liability.
- 5) NYS licensed Appraisers are not able to consider the impact on value if a gas lease exists as noted it item #1 above and hence their Appraisals would not meet Secondary market requirements.

- 6) Surface or sub surface rights within 300 feet of a residential structure OR within 300 feet of property boundary lines would not be acceptable for FHA (Department of HUD) financing.

For purposes of this discussion, I will utilize the word “lender” or “bank” to refer to traditional banks as well as credit unions and mortgage bankers.

In general terms, banking regulators on a federal and state level monitor how much a bank has in lending compared to deposits and assets. The regulators also establish certain requirements for bank liquidity, funds not loaned or pledged in some fashion, in an effort to provide for a sound financial system. The same holds true for credit unions and their regulators.

In an effort to provide a steady and potentially unlimited source of funding for residential mortgage loans, the secondary market was established and remains one of the only consistent methods for lenders to provide affordable and consistent funding for residential mortgage lending. Most lenders utilize secondary market standards for underwriting and property review. These standards allow a lender to sell loans to Fannie Mae, Freddie Mac or other investors because of the known and accepted standards and a track record of performance.

In addition, to secure the FHA Insurance or VA Guarantee, these government programs have established similar underwriting and minimum property standards that are required to be followed.

Without the mortgage secondary market, banks would only be able to lend based on the assets (or deposits) they have available. Once those assets are fully loaned, they would not be able to lend additional funds until one of the current loans were paid in full. With the secondary market, banks are able to lend, sell the mortgage to Fannie Mae, Freddie Mac or another investor and then relend those same funds to another borrower. This process provides for a consistent, equitable and affordable method for borrowers to purchase homes.

The issue of leased land to gas or oil companies creates challenges for banks. Below is a summary of those challenges linked to the numbers noted on page one:

- 1) Secondary market requirements establish property value for residential properties by comparable sales (similar properties that have sold within a short time and distance from the subject). Since there is not a reliable mapping system to identify properties with gas leases, the appraiser is not able to identify potential comparable properties. In addition, many gas leases only have a memorandum of lease recorded which do not provide the necessary details to compare leases.
- 2) Secondary market requirements state (Freddie Mac guide 39.4 (i)):
 - a. Exceptions for outstanding oil, gas, water or mineral rights are acceptable if commonly granted by private institutional Mortgage investors in the area where the Mortgaged Premises are located, and:

- i) The exercise of such rights will not result in damage to the Mortgaged Premises or impairment of the use or marketability of the Mortgaged Premises for residential purposes and there is no right of surface or subsurface entry within 200 feet of the residential structure, or
 - ii) There is a comprehensive endorsement to the title insurance policy that affirmatively insures the lender against damage or loss due to the exercise of such rights

- 3) A Title insurance comprehensive endorsement in NYS may contain the following restrictions which would likely result in the title insurance coverage being compromised or ineffective. Typical gas leases allow gas companies to perform these activities. The loss or inability to provide title insurance would restrict lending on properties with gas leases if title insurance was not available.
 - a. No structure shall be erected on the premises which exceeds three (3) stories or thirty five (35) feet in height...
 - b. The premises shall not be used for the storage of any material, machinery, equipment or supplies of any kind...
 - c. The premises shall not be used for any commercial purpose of any kind...

- 4) Secondary Market requirements state (Freddie Mac guide 39.4 (m)) that lenders must warrant the following, each of which would not be possible with gas/oil leases in place. These leases specifically restrict future use of the property by the borrower or owner. In addition, there is not reliable data to support what impact a gas lease has on value or marketability:
 - a. ...must not interfere with the use and enjoyment of any present or proposed improvements on the mortgaged premises or with the use and enjoyment of the balance of the Mortgage Premises not occupied by improvements.
 - b. ...must not affect the marketability of the Mortgaged Premises
 - c. ...must have no or minimal effect on the value of the Mortgaged Premises
 - d. ...must be commonly acceptable to private institutional Mortgage investors in the area...

Banks could not warrant any of these issues due to lack of comparable sales and details regarding gas leases attached to other properties.

- 5) Secondary market requirements state (Freddie Mac guide 44.3 (d)) regarding any detrimental conditions such as underground mines... “The Appraiser must also consider the effect of such conditions in estimating the subject property’s market value and/or marketability.” Since there is not any way to determine if other gas/oil leases exist, the Appraiser can not fulfill this requirement.

- 6) FHA requirements are similar in all forms to the above with the exception that FHA requires there is no right of surface or subsurface entry within 300 feet of the residential structure OR within 300 feet of the property boundary lines

CONCLUSION:

While the secondary market and FHA do not specifically prohibit gas and/or oil leases, the following items, as addressed above, cause a high level of concern for prudent banks and lenders.

1) Comparable sales, subject to gas/oil leases, are not able to be documented reliably at this time by NYS licensed appraisers. Many of the leases are recorded only in memorandum form so it is impossible for the appraiser to be able to review comparable leases and perform the duties and responsibilities of the Appraisal standards.

2) Historical data to support value and marketability is not able to be documented reliably at this time by NYS licensed appraisers. Tax roles, assessment roles, multiple listing databases and other forms of determining property sales have not and currently do not track the existence or terms of gas/oil leases. Therefore, the impact, either positive or negative, on value and marketability is not able to be documented reliably at this time by NYS licensed appraisers.

3) Since the appraisers can not supply the comparable sales, historical data and conclusive impact on value and/or marketability, the appraisal report they produce would not meet secondary market minimum standards, banking regulatory standards or NYS Appraisal standards. That would leave the lender with exceptional liability to warrant for value and marketability that the appraiser has not documented with data as being supported by comparable sales, historical data, etc.

4) It has been previously reported that Gas/oil leases are generally NOT routinely accepted by lenders such as Wells, First Place Bank, Provident Funding, GMAC, FNCB, Fidelity, FHA, First Liberty or Bank of America, to name a few. It would be difficult, if not impossible, to meet the "acceptable if commonly granted" rule.

5) The set back of 200 feet noted above means 200 feet each direction for a lot size of at least 440 x 440 or 193,600 sf or 4.48 acres...to account for the house, well, septic size...hence the need to release 5 acres from all lease rights. 1 acre = 43,264sf. 5 acres = 216,320 sf.

6) FHA loans are more commonly utilized by lower income borrowers and lower valued properties. For FHA, the set back of 300 feet noted above means 300 feet each direction for a lot size of at least 640 x 640 or 409,600 sf or 9.47 acres...to account for the house, well, septic size...hence the need to release 10 acres from all lease rights. 1 acre = 43,264sf. 10 acres = 432,640 sf. This does not address the 300 feet from property boundary lines issue and will related to #7 below.

7) If the property is set closer to the road or a property boundary than the 200 or 300 ft setback, a neighboring property that has a gas lease may prevent the un-leased property from being able to be financed. A central reporting database on all gas leases mapped is needed to allow appraisers to determine if a neighboring property has a gas lease. Currently the only method to determine if a gas lease exists is to have an attorney do a title review on surrounding properties that would add significant expense and time delays to each residential transaction.