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Rush to Drill for Natural Gas Creates Conflicts With Mortgages

By IAN URBINA

As natural gas drilling has spread across the country, energy industry representatives have sat down at kitchen tables in states like Texas, Pennsylvania and New York to offer homeowners leases that give companies the right to drill on their land.

And over the past 10 years, as natural gas has become increasingly important to the nation's energy future, Americans have signed more than a million of these leases.

But bankers and real estate executives, especially in New York, are starting to pay closer attention to the fine print and are raising provocative questions, such as: What happens if they lend money for a piece of land that ends up storing the equivalent of an Olympic-size swimming pool filled with toxic wastewater from drilling?

Fearful of just such a possibility, some banks have become reluctant to grant mortgages on properties leased for gas drilling. At least eight local or national banks do not typically issue mortgages on such properties, lenders say.

A credit union in upstate New York has started requiring gas companies to promise to pay for any damage caused by drilling that may lead to devaluation of its mortgaged properties. Another will make home loans only to people who expressly agree not to sign a gas lease as long as they hold the mortgage.

More generally, bankers are concerned because many leases allow drillers to operate in ways that violate rules in landowners' mortgages. These rules also require homeowners to get permission from their mortgage banker before they sign a lease — a fact that most landowners do not know.

Last year, Jack and Carol Pyhtila spent several weeks working to refinance the mortgage on their roughly 30 acres in Tompkins County, N.Y. But when they arrived to sign the mortgage, the lender, Visions Federal Credit Union, had taken a closer look at the lease on their land and revoked its offer, said Mr. Pyhtila, 72.

“They told us there was not enough information yet to know how the lease would affect the property value and they were not sure if it followed the mortgage rules,” he said. Another bank agreed to refinance their loan several months later.

Lenders predict that the conflicts between leases and mortgage rules are not likely to cause foreclosures, nor have they resulted in broad litigation or legislation. But many of the leases do constitute “technical defaults” on the mortgages, lenders say, and will likely result in new rules from local banks and additional hurdles to getting a home loan or refinancing a mortgage.

Some real estate agents have started raising red flags.

“When you decide to sell your house you may find it difficult to do so because many banks, here and elsewhere, will not mortgage properties with gas leases, which, in turn, limits the number of buyers willing and able to buy your property,” wrote Linda Hirvonen, an agent in Ithaca, N.Y., in a newsletter last month.

Banks establish rules for how mortgaged properties can be used, to help ensure that they will hold their value. Banks also need to guarantee that their mortgages meet certain standards so that they can sell them to institutions like Fannie Mae and Freddie Mac, which bundle and sell these mortgages to investors.

“In terms of litigation, there is a real potential for a domino effect here if lenders at each step of the way made guarantees that are invalid,” said Greg May, vice president of residential mortgage lending at Tompkins Trust Company, headquartered in Ithaca.

Banks resell more than 90 percent of new residential mortgages in the United States to institutions like Fannie Mae, Freddie Mac and Ginnie Mae. It is not clear how many mortgages held by major secondary lenders or investors have oil or gas leases on them that do not comply with mortgage rules.

But if even a small percentage do, tens of billions of dollars in mortgages might be affected, raising new concerns for an industry that has suffered in recent years from home loans that proved much riskier than expected.

Some lawyers who specialize in oil and gas leases said they were not worried.

“The leases have not created any practical conflict or issue with mortgages,” said Adam J. Schultz, a lawyer in Syracuse, adding that there are thousands of gas leases on mortgaged properties in New York and Pennsylvania and that state environmental regulations helped protect property values.

Most of the bankers and mortgage experts interviewed also emphasized that they were not opposed to expanded drilling. The surge in such drilling has created thousands of jobs, bolstered American energy supplies and turned some landowners into millionaires, they said.

However, the banking industry is only starting to appreciate the complexity and possible consequences, they added.

“It’s truly Pandora’s box,” said Cosimo Manzo, a vice president of First Heritage Financial, a mortgage services company in Philadelphia, during a presentation to Pennsylvania lenders posted online in July by a state credit union association. He also compared getting leases to comply with mortgage rules to solving a Rubik’s Cube.

If local banks do not require that leases comport with mortgage rules, Fannie Mae and Freddie Mac may stop buying mortgages from these banks, Mr. Manzo said. Other experts warned that the two institutions, or investors who bought mortgage-backed securities, may also force local lenders to buy back noncompliant mortgages.

Real estate experts said the chances for conflicts between leases and mortgages were growing as drilling increased in more populated areas. The issue has garnered the most attention among lawmakers and lenders in New York, partly because the state’s rules for how close to homes drilling may be undertaken are more lax than in some Western states where there has been drilling for years.

Attention From Lawmakers

Lawmakers have started asking more questions about the interplay of leases and mortgages.

In September, after The New York Times asked them about the issue, two Democratic congressmen, Edward J. Markey of Massachusetts and Maurice D. Hinchey of New York, asked Fannie Mae and Freddie Mac how they intended to rectify any breaches of their standards caused by drilling leases. State legislators from New York, Ohio and Maryland have also sent letters to regulators seeking more information.

In October, Mr. May published a report after a Tompkins County legislator, Carol Chock, asked him to look into the issue. The report described various conflicts between leases and mortgages over such things as minimum distances between gas wells and homes and the construction of wastewater ponds.

Mr. May said the issue was causing “a high level of concern for prudent banks and lenders.” He and other bankers have also questioned how the growing grid of buried pipelines that carry natural gas from wells to consumers will comply with mortgage rules. A separate report from the Congressional Research Service, the research arm of Congress, said signing a drilling lease without prior approval on a property with a mortgage owned or guaranteed by Fannie Mae or Freddie Mac “generally will be considered an act of default under the mortgage.”

That could give either of the federally run companies the right to demand immediate payment of the full loan and even foreclose on the property if the owner cannot pay, the report said.

Representatives for Freddie Mac, Fannie Mae and the Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac, declined to comment.

Other officials at Fannie Mae, who were not authorized to speak to reporters, said it was unclear how many mortgaged properties with noncompliant leases Fannie Mae owned or had unwittingly sold to investors. Since drilling leases are frequently on farms and Farmer Mac, which purchases farm, ranch and rural homeowner mortgages, has many of the same rules as Fannie Mae and Freddie Mac, potential conflicts between mortgages and leases exist there, too.

A spokesman for Farmer Mac said he did not believe leases posed a significant financial risk.

Some bankers have emphasized that the conflicts between mortgages and leases can be resolved. But that first requires more guidance from Fannie Mae, Freddie Mac and other secondary lenders about what types of appraisals and title insurance are appropriate for mortgaged properties with leases, and whether the risks and values of these properties need to be reassessed, said Bill Crane, a senior vice president of CFCU Community Credit Union in Ithaca.

Other lenders said they needed mortgage rules relating to leased properties to be followed uniformly so that bankers who enforced these higher hurdles were not left at a competitive disadvantage.

In New York, these lenders added, regulators need to change regulations to require a larger buffer zone between homes and wells so that drilling complies with mortgage rules.

“New York needs the drilling jobs,” said Ralph Kelsey, a senior vice president of Tioga State Bank in Tioga County, N.Y. “We also need a lot more answers to these questions.”

Last year, Mr. Kelsey gave a presentation warning that since intensive drilling is relatively new in New York and Pennsylvania, there is a lack of historical data about how drilling affects property values, which in turn raises questions about whether appraisals will meet mortgage guidelines.

Rare Requests for Clearance

Data is scarce on how often landowners or drilling companies are getting written permission from lenders before putting leases on mortgaged properties. Most mortgage experts said the requests were rare.

Bank of America receives roughly 100 requests per month nationwide, a company spokesman said. Fewer than a dozen such requests are sent directly to Fannie Mae each year, according to Fannie Mae officials.

Wells Fargo, Bank of America, Citigroup, JPMorgan Chase, HSBC, GMAC Mortgage and the Mortgage Bankers Association declined to comment beyond saying they decided mortgages case by case and noting that the landowner or the gas company is responsible for ensuring leases do not violate mortgages.

In private e-mails, some lenders said drilling leases could create problems for getting a mortgage.

It is “very difficult to obtain financing due to the potential hazard” as well as “unknowns,” an official at Wells Fargo wrote to a mortgage broker in northeastern Pennsylvania in April 2010.

Drilling officials offered a different view. They said that the income from lease bonuses and gas royalties actually enhanced property values, and that mortgage lenders welcomed gas drilling because it provided borrowers with extra income that could be used to pay off their mortgages.

New York environmental regulators recently published a report indicating that property values go up regionally with an influx of drilling jobs. But the report also said research showed the value of properties closest to drilling would likely decrease.

Chesapeake Energy, a major natural gas producer, does not seek approval from lenders before finalizing leases on mortgaged properties but asks permission later for properties where wells will be drilled and withholds royalties until consent is obtained, said Jim Gipson, a company spokesman.

However, lenders warned that mortgage rules required approvals from lenders before drilling leases were signed. They also noted that such approvals were required on all leases, not just those where wells are drilled.

Landowners said they were unaware of the rules set by their mortgages.

“It never even dawned on me to talk to the bank before I signed my lease,” said Marie McRae, 67, who raises horses in Freeville, N.Y., outside Ithaca. She leased 13 acres of her farm in 2008, but came to regret her decision and has publicly criticized drilling.

Asked by The Times to review the mortgage regulations and a collection of leases, Shaun Goho, a lecturer in the Emmett Environmental Law and Policy Clinic at Harvard Law School and co-author of a guide to natural gas leasing, said he was alarmed by various potential conflicts between leases and mortgages. He added that the clinic planned to revise the guide this fall to include a discussion of these conflicts.

Officials from Exxon Mobil, the largest natural gas producer in the United States, and America’s Natural Gas Alliance, a trade association, declined to comment.

This is not the first time that questions have been raised about whether mortgages comply with standards set by major lenders.

The assembly-line way that mortgages are sold and resold makes it difficult to track liability and risk and to ensure that guidelines are being followed, said Eric Forster, a real estate and mortgage expert who is the managing principal in Forster Realty Advisors of Los Angeles, which often consults on real estate litigation.

“The subprime mortgage mess was the first symptom of this larger problem,” he said. “And these leasing issues represent a second symptom.”

Kitty Bennett contributed research.