STATEMENT

before
the
California Legislature
Assembly Banking and Finance Committee and Assembly Local Government Committee

Keeping Up with PACE: A Joint Oversight Hearing on Residential Property Assessed Clean Energy (PACE) Programs

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Chair Dababneh, Chair Eggman, Vice Chair Allen, Vice Chair Waldron, Committee Members, in response to your request for input on Property Assessed Clean Energy (PACE) programs, I am pleased to have the opportunity to address this Joint Oversight Hearing. My name is Alfred Pollard and I serve as General Counsel of the Federal Housing Finance Agency (FHFA). Our agency oversees the eleven Federal Home Loan Banks (FHLBanks), which accept mortgage collateral in exchange for advances to financial institutions in the primary mortgage market, and Fannie Mae and Freddie Mac (the Enterprises), which purchase and also securitize mortgages thereby providing resources to the primary mortgage market. To facilitate these remarks and because of their role in purchasing first-lien mortgages, I will focus on Freddie Mac and Fannie Mae.

As you know, the Enterprises are in federal conservatorships and have received more than $187 billion in federal government support to remain in operation and support the primary mortgage market. During the conservatorships, the Enterprises have refinanced over 22 million mortgages into lower interest rates, providing more affordable home loans and they have undertaken over 3.6 million foreclosure prevention actions through various programs to keep homeowners in their homes.

Oversight Hearing

Today's hearing is about residential energy retrofit lending. In short, this means the financing for a product, not the retrofit product itself. While the product is timely and important, the financing method is at the core of today's discussion. Whether funded by a PACE loan or a second-lien loan, the energy efficiency product would be the same. The financing method has significance for homeowners, communities, small lenders that hold loans in portfolio, the FHLBanks, the Enterprises and those who own mortgage-backed securities, such as pension funds. In 2009-2010, as you may know, FHFA and the bank regulators along with major financial institution trade groups expressed concerns with the PACE model as the financing mechanism for lending programs. As conservator for the Enterprises, FHFA has stated it cannot support first-lien PACE programs for Enterprise participation and I hope these remarks assist in understanding why that remains FHFA's position.

Energy Efficiency Financing

FHFA supports energy efficiency efforts by homeowners and home purchasers. Later in an attachment to this presentation, I address, in detail, FHFA's efforts and those of the entities the Agency regulates that support energy efficiency improvements and energy efficiency financing.

As noted, the topic is what methods should be employed to finance retrofitting a home with energy efficient products, with a primary, though not exclusive, focus on solar products. PACE initiatives contemplate state legislation to authorize counties and municipalities to administer programs to finance homeowner retrofits. By working through the counties, PACE programs seek to secure a first-lien position for their loans as this would prove attractive to investors. With a few exceptions, counties and cities that have undertaken PACE programs engage outside firms to administer them.

The programs in California and elsewhere look principally to the value of property to support a loan, rather than the ability of a homeowner to repay, as was mandated in the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010. The focus on ability to repay, by no means a new concept, aimed to correct the asset-based lending that contributed to the financial crisis that began in 2007. In addition to undertaking asset-based lending, the counties or municipalities may charge up to 10 percent for administrative fees and other charges are imposed by administrators; these numbers are generally well beyond what a second-lien mortgage loan would contemplate. Total authorized amounts for loans vary by state from 10 percent or more of assessed home values.

Stated consumer protections are narrow— generally limited to basic underwriting for a loan such as that a borrower must not have filed for bankruptcy, not be behind on a mortgage or been delinquent on property taxes. Beyond that, it is up to localities to determine what protections to afford consumers. Even where protections exist, they are not uniform and have no enforcement agency behind them.

FHFA and PACE

Because of the transfer of risk to the Enterprises and the FHLBanks by PACE programs through the first-lien status they obtain, FHFA has made clear that the FHLBanks should undertake such actions as they deem appropriate to protect collateral they acquire and that Fannie Mae and Freddie Mac should neither purchase nor refinance mortgages with PACE loans attached. While the Enterprises have additional authorities to protect their first-lien status, FHFA has directed only these actions to date.

The PACE lien is referred to as a "super-lien" as it moves ahead or "primes" a first mortgage lien. Further, a PACE lien often represents a retroactive creation of liability on a property ahead of the existing first-lien mortgage, which the mortgage holder neither knows about nor consents to. The creation of a super-lien thus transfers the risk of loss to the first-lien mortgage holder after the lender has already underwritten and entered into a financing arrangement that facilitates the purchase or refinancing of a home. The lender has no knowledge and no say in the subsequent additional risk and the potential decline in the value of their collateral by the layering of debt.

In a public statement dated December 22, 2014, FHFA summarized that—

> The existence of these super-priority liens increases the risk of losses to taxpayers. Fannie Mae and Freddie Mac, while operating in conservatorship, currently support the housing finance market by purchasing, guaranteeing, and securitizing single-family mortgages. One of the bedrock principles in this process is that the mortgages supported by Fannie Mae and

> Freddie Mac must remain in first-lien position, meaning that they have first priority in receiving the proceeds from selling a house in foreclosure. As a result, any lien from a loan added after origination should not be able to jump in line ahead of a Fannie Mae or Freddie Mac mortgage to collect the proceeds of the sale of a foreclosed property.

In brief, Enterprise programs support the ability of a borrower to purchase a home and the Enterprise mortgage is recorded first in time. A PACE loan is only available to someone who owns a home. In the vast majority of cases that ownership is obtained by a mortgage loan in which a lender has placed hundreds of thousands of dollars at risk. Accordingly, Fannie Mae and Freddie Mac, when they purchase loans, require at all times that they remain in a first-lien position. Also, the congressional charters for the Enterprises require that the borrower have at least 20 percent equity in a home or an approved form of credit enhancement, such as mortgage insurance, to address the risk of nonpayment. A PACE loan can erode— partially or completely— that 20 percent equity cushion.

PACE is a lending program created to attract investors to provide funds for loans for energy retrofits. Unlike normal home improvement financing, the PACE program seeks to secure a first lien on property for a loan through a governmental property tax lien. The financing concept is simple— if a residential property has to lose 90 percent of its value before a PACE lender incurs a loss, the investor has a very attractive investment opportunity. However, that opportunity comes at the expense of existing lien holders, who unexpectedly bear a new risk of loss, and, in some instances, to the disadvantage of consumers.

PACE programs transfer risk. PACE programs fundamentally do not have comprehensive regulatory supervision. PACE programs have no required uniformity. PACE programs in many, but not all, instances are administered by third parties that do not follow the same consumer protection requirements applicable to residential mortgage lenders.

FHFA Director Melvin L. Watt has been clear— super-priority liens ahead of Enterprise loans transfer undue risk and only true second-lien status avoids this problem. In other words, FHFA cannot sanction first-lien status PACE programs for Enterprise participation. Court cases across the country have upheld the Agency's directions on this point. Liens running with properties that are not extinguished through foreclosure are not true second liens, even if termed "subordinated."

Let me add that this position would be true even if the Enterprises were not in conservatorships, where taxpayers bear the risk of loss being transferred to them. But they are in conservatorships and the conservator is bound by statute to "preserve and conserve" Enterprise assets. Permitting a hidden or future lien to defeat or impair recourse to collateral— the basis for secured lending— has market implications.

Energy Efficiency Efforts

FHFA is mindful of the interest of California and other jurisdictions in promoting energy efficiency. For that reason, FHFA supports Enterprise activities that promote energy efficiency improvements and favorable consumer financing. To that end, I have provided an Attachment to highlight for the Committees information on FHFA and Enterprise activities and programs that support energy efficiency. These programs benefit from uniformity, sound underwriting and a regulatory regime that oversees and examines the loan financings.

To the Chairs, Vice Chairs and Members of the Committees, I hope that this information has been helpful to you and I am happy to answer any questions that you have.

ATTACHMENT

Energy Efficiency Efforts

FHFA, Fannie Mae and Freddie Mac

The following information summarizes efforts by FHFA and Fannie Mae and Freddie Mac to facilitate financing of energy efficient energy products:

1. *2016 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions*

FHFA annually provides a Scorecard of its expectations for Enterprise performance on a range of products and other priorities during the conservatorships. At the end of each year, FHFA reviews achievements in line with the Scorecard.

In its Scorecard for 2016, FHFA has called upon the Enterprises to "Evaluate options that would enable greater liquidity for Enterprise financing of energy or water efficiency investments in single-family and multifamily properties." This supports expansion of efforts for energy retrofit lending.

2. *Proposed Duty to Serve Rule*

On December 18, 2015, in the *Federal Register*, FHFA proposed a new Duty to Serve rule. The comment period closed on this proposed rule in March and FHFA is reviewing comments. Duty to serve refers to a statutory requirement that Fannie Mae and Freddie Mac provide services for moderate, low- and very low-income communities. As part of the rulemaking, FHFA proposed for public comment an approach to preserving affordable housing that would include "…(3) Energy efficiency improvements on existing single-family, first-lien properties, provided that there are verifiable, reliable projections or expectations that the improvements financed by the loan will reduce energy and water consumption by the homeowner or tenant…" *See* FHFA, Proposed Rule, *Enterprises Duty to Serve Underserved Markets*, 80 FR 79181 [based on 12 USC 4564; proposed rule at 12 CFR 1282 (energy efficiency proposal at section 12 CFR 1282.34 (d)(3); 80 FR 79200-202)].

FHFA is reviewing the comments on the proposed rule and I cannot predict a final outcome. However, I can report that we did receive a good range of input on the questions raised regarding the energy efficiency proposal.

3. Enterprise Programs

In addition to working on new approaches under the Scorecard and proposed Duty to Serve regulation, both Freddie Mac and Fannie Mae have active programs relating to energy efficiency and conservation improvements for single-family homes. A few of the existing and potential programs are listed below. Clear benefits of these programs include: that they are uniform in nature (including flexibility to meet certain local conditions); that they are underwritten to protect consumers and reduce risks to the Enterprises; and, that they are overseen by a federal regulator with examination and enforcement authorities.

Freddie Mac

Freddie Mac's Single-Family program supports financing to borrowers for energy efficient and renewable energy home improvements. Freddie Mac finances properties with such improvements through any mortgage product and property type eligible for lenders under its *Single-Family Seller/Servicer Guide.*

Freddie Mac's Single-Family Guide flexibilities relating to energy conservation improvements include:

(A) providing financing for energy improvements with no cap on the "as completed" value;
(B) permitting energy reports/audits or appraisals to indicate the efficiency of the property;
(C) allowing energy-related improvements on all properties including manufactured homes and new construction;
(D) for Manually Underwritten Mortgages, energy efficiency improvements can be used as a compensating factor to qualify for a higher expense-to-income ratio and debt-to-income ratio above the 36 percent cap;
(E) Home Possible and Home Possible Advantage℠ , which are specialized 95 and 97 percent loan-to-value ratio products, may be used to finance a property with energy efficient enhancements;
(F) no objection to secondary financing, such as HELOCs, for energy efficient products;
(G) permit use of Freddie Mac's Affordable Seconds for nonprofits when financing mortgages secured by property with energy efficient improvements; and,
(H) proceeds of a cash-out refinance transaction may finance energy efficient improvements or payoff any other debt, including a PACE obligation.

Freddie Mac is committed to continuing its consideration of innovative methods of providing responsible, sustainable energy retrofit loan products.

Fannie Mae

Fannie Mae likewise has a number of single-family loan products and projects underway related to energy improvements. Among these are the following:

(A) announcement earlier this year of new HomeStyle® Energy mortgage funding up to 15 percent of the as-completed appraised value toward new energy-efficient upgrades for purchases or refinances subject to an energy use report. Expenses up to $3,500 for weatherization or water efficiency may be made without a report. Program may be used to pay off an existing PACE loan or unsecured debt related to energy-efficient upgrades;
(B) HomeStyle® Renovation mortgage for general (including energy-related) rehabilitation of existing homes in purchases or re-financings permits up to 50 percent of as-completed appraised value;
(C) flexible rules for energy efficiency enhancements which include (1) permitting non-profit funding of energy improvements under both Community Seconds mortgages and down payment assistance programs and (2) increase in the maximum debt-to-income ratio above 36 percent for manually underwritten loans for energy efficient homes; and,

(D) work with a consortium of nationally-active solar panel leasing companies to revise Fannie Mae standards to better accommodate mortgage lending to consumers who wish to lease, rather than purchase, solar power equipment for use at their home.

Fannie Mae will continue to consider additions to HomeStyle Energy® and to undertake projects with lenders to improve home energy efficiency data that may be useful to homeowners and home purchasers, mortgage lenders, real estate professionals and appraisers, and homebuyers in order to enhance underwriting and data reliability.