FHA Clarifies Financing on Properties with PACE Loans

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Property-Assessed Clean Energy (PACE) loans can be taken out to finance energy-efficient upgrades, including solar panels, energy-efficient air conditioning, new windows, insulation, or a water conservation system. Under current rules, residential PACE improvements are typically assessed with property taxes and have a lien priority on par with tax liens, placing them above other liens that may be on the property, including the first mortgage. The structure of this financing has historically limited the use of the program, as the Federal Housing Finance Agency (FHFA), the regulator of the government-sponsored enterprises (GSEs) has prohibited these institutions from purchasing or guaranteeing mortgages with a PACE loan attached. The Federal Housing Administration (FHA) has also been reluctant to make loans on homes with a senior PACE lien. Some PACE loan providers have made it clear that they are willing to subordinate the PACE lien, as long as the lien can travel with the property.

On August 24, 2015, FHA stated that it would make financing available for single-family homes with existing subordinated PACE loans, as long as certain conditions are met. On July 19, 2016, as part of the Clean Energy Savings for All Americans Initiative—a cross-government partnership involving the US Departments of Agriculture, Energy, Health and Human Services, Housing and Urban Development (HUD), and Veteran's Affairs, as well as the Environmental Protection Agency, designed to increase access to solar energy and promote energy efficiency—HUD clarified the conditions under which properties with PACE assessments can be purchased and refinanced with FHA loans. The Veteran Administration will also allow properties with PACE assessments to be purchased and refinanced with Veterans Affairs loans.[1]

The most important condition for allowing a home with existing PACE financing to obtain an FHA-insured loan is that the PACE lien be subordinated but be permitted to travel with the property—that is, it can be transferred from one property owner to the next, including through a foreclosure sale. In addition, to protect the successive property owner, the PACE obligation must be readily apparent to mortgagees, appraisers, borrowers, and other parties to an FHA-insured mortgage transaction, and information on PACE obligations must be readily available for review in the public records where the property is located.[2] Finally, to gather further information about how these loans affect the property's value, the appraiser must analyze and report on the impact of PACE-related improvements to the property's value.[3]

This is a huge step forward: it is the first time any government agency has agreed to insure or guarantee properties with PACE loans. Resolving the regulatory uncertainty by allowing subordinate liens to travel with the property should pave the way for an increased volume of energy-efficient improvements. Requiring the PACE lien to be subordinate to the FHA mortgage protects the FHA; allowing the lien to travel with the property is important to encourage the product's use.

It is critical to the PACE market that the lien travel with the property for two reasons. First, many consumers are unsure how long they will be in a home and may be more reluctant to purchase a more expensive and more efficient product if it must be paid off when the home is sold. Energy-efficient enhancements benefit both consumers and society, and it is in the public interest to encourage these enhancements. Second, PACE loans are an emerging asset class; the loans cannot be made unless investors are willing to hold them. The loans will clearly trade better, especially in securitization form, if they can travel with the property, resulting in better rates and greater credit availability for consumers. If the lien was extinguished during foreclosure, it would affect the pricing on these instruments to the borrower.

FHFA Status on PACE Assessments

The FHFA has sent mixed signals on whether they can be comfortable with subordinate PACE loans on the same terms as the FHA. On one hand, the FHFA has indicated it is comfortable with Vermont legislation: the lien is subordinated to all liens on the property that exist when the PACE loan is filed and to all first mortgages recorded after the PACE loan, but the lien is permitted to run with the property. This statute did include a reserve fund to protect against losses because of foreclosure. On the other hand, recent statements by the FHFA suggest discomfort with having an assessment traveling with the property under any circumstances. For example, in June 2016, Alfred Pollard, general counsel of the FHFA, testified before the California legislature raising two concerns. First, even if the lien is subordinated, it is not really subordinate if it is not extinguished through foreclosure and is permitted to travel with the property. Second, PACE loans do not follow the same consumer protection requirements applicable to residential mortgage lenders (Pollard 2016). This short note addresses both issues.

The Effect of PACE Improvements on Property Value

The issue from the FHFA's point of view is that they believe if a GSE loan with a PACE lien goes to foreclosure and the lien travels with the property, the FHFA will receive less in proceeds than if the home did not have the improvements or the assessment. This argument assumes that the value of the property does not increase enough to offset the lien. In fact, in an empirical study I did with Jun Zhu, published in the *Journal of Structured Finance*, we show that energy-efficient improvements increase the value of the property by more than the PACE assessment (Goodman and Zhu 2016).[4]

We used data from Renovate America, the largest provider of PACE loans in California, with roughly an 80 percent share of that market. The California market is the largest for PACE improvements in the nation.

The data included all 773 loans on which Renovate America had financed an improvement and the home was later sold. The homes were purchased as early as 1976, the PACE improvement was made after Renovate America entered the market in 2011, and the home was sold between 2012 and mid-2015.

We used three methodologies in our analysis. First, we compared the sales prices on homes with PACE assessments (taking the project's costs into account) with the prices on those that would be predicted by home price indices based on the zip code and original purchase date of those homes. Depending on the index, we found the homes' resale value demonstrated a positive PACE premium of $199 to $8,882.

We also compared the PACE home with a matched sample of loans in the same zip code that had homes purchased and sold at the same time. The matched sample was randomly selected from loans that met the criteria. The gain on the PACE homes was $5,010 more than the gain on the non-PACE loans. Furthermore, 92 percent of the PACE loans had a sales price (adjusted for the PACE assessment) higher than the purchase price, versus 87 percent of the non-PACE sample.

Finally, we pooled the PACE loans with the matched sample and ran regressions, controlling for characteristics such as purchase price, square feet of living space, number of baths, and whether the property had a PACE loan. The regression coefficient on the PACE loan indicates that after netting out the assessment, the energy-efficient improvement added $4,042 to the sales price.

Regardless of methodology, we found the PACE improvement more than offset the cost by $199 to $8,882. Homeowners can more than fully recover their full costs at resale, whereas most other home improvements can recover only about 60 percent. While we have few data points on the sale price of homes that went into foreclosure with PACE improvements (the source of FHFA concern), many homeowners opt for a PACE-financed energy-efficient improvement when the original equipment breaks. These borrowers are willing to invest in their homes, rather than opt for a less good, more inexpensive fix or none at all, suggesting they are less likely to go to foreclosure. And if they do go to foreclosure, the correct comparison is the home with the improved collateral versus the unimproved foreclosed home, which may have broken equipment.

Consumer Protections

The second point Pollard made in his California testimony is that PACE loans are not subject to the same level of consumer protections that other mortgage loans have, such as the ability-to-repay tests. The ability-to-repay rule ensures mortgage products are standard: rates are fixed for at least five years, no interest only loans, no loans with prepayment penalties, and so on. (There are no debt-to-income restrictions on GSE loans.) And all PACE loans are fixed rate with terms of five years or more, are fully amortizing, and have no prepayment penalties. These loans are more stringent than the ability-to-repay rules in that PACE loans limit the assessment term to the useful life of the improvement. Moreover, there is some underwriting on the borrower: typically he or she must be current on property taxes and cannot have had more than one late payment over the previous three years, and must be current on all mortgage debt and cannot have had more than one late payment over the previous 12 months. The property cannot have any federal or state income tax liens, judgment liens, or mechanic's liens. The borrower cannot have been involved in a bankruptcy proceeding during the previous two to seven years, depending on the area.

More importantly, many PACE loans have other consumer protections that matter for this type of home improvement product: restrictions to make sure the improvement costs are not so large relative to the home that the value cannot be recaptured, assurances that the contractor is legitimate, the contractor's fees are reasonable for the work done, and assurances that the work is completed in a satisfactory manner. In the Renovate America product, assessments originated before January 1, 2015, cannot be more than 10 percent of a property's value, 15 percent for most assessments originated after January 1, 2015. Mortgage debt cannot be more than 90 percent of a property's value before the assessment, 100 percent afterward. Most PACE loan providers require that the contractors be licensed, bonded, and insured. Projects are subject to a maximum finance amount across all major product types, and projects quoted beyond the ranges require special approval. The PACE provider does not pay the contractor until the homeowners sign a certificate assuring satisfactory project completion. The contractor must also ensure the proper permits have been obtained for the improvements.

We applaud HUD for embracing the PACE product in a manner that protects HUD and encourages homeowners to employ energy-efficient enhancements to their home by allowing the lien to travel with the property. We hope the FHFA allows the GSEs to make loans on properties with a PACE assessment on roughly similar terms, as we believe the GSEs would be at least as well off by making a loan on a home with an energy-efficient improvement and a PACE assessment as it would be in making a loan on a home that did not have the improvement or assessment.

Notes

1. Office of the Press Secretary, "Fact Sheet: Obama Administration Announces Clean Energy Savings for All Americans Initiative," news release, July 19, 2016, https://www.whitehouse.gov/the-press-office/2016/07/19/fact-sheet-obama-administration-announces-clean-energy-savings-all.
2. Brian Sullivan, "FHA to Insure Mortgages on Certain Properties with PACE Assessments," news release, July 19, 2016, http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2016/HUDNo_16-110.
3. Edward Golding, "Property Assessed Clean Energy (PACE)," Mortgagee Letter 2016-11, US Department of Housing and Urban Development, July 19, 2016, http://portal.hud.gov/hudportal/documents/huddoc?id=16-11ml.pdf.
4. The research conducted by the author and later published in the *Journal of Structured Finance* was funded by Renovate America and was not a product of the Urban Institute.

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Goodman, Laurie S., and Jun Zhu. 2016. "PACE Loans: Does Sale Value Reflect Improvements?" *Journal of Structured Finance* 21 (4): 6–14. http://www.iinews.com/site/pdfs/JSF_Winter_2016_PACENation.pdf.

Pollard, Alfred M. 2016. Statement before the California Legislature, Sacramento, CA, June 9, 2016. http://www.fhfa.gov/Media/PublicAffairs/Pages/Pollard-Statement-before-California-Legislature-Keeping-Up-with-PACE.aspx.