

ABS Research

What Accounts for Recent Volatility in Residential PACE Prepayments?

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Analysts:

Stephanie K. Mah | Vice President | stephanie.mah@morningstar.com | +1 646 560-4571
Phoebe Xu | Senior Vice President | phoebe.xu@morningstar.com | +1 646 560-4562

Analytical Manager:

Rohit Bharill | Managing Director | rohit.bharill@morningstar.com | +1 646 560-4543

Morningstar Perspective

Despite relatively limited performance data, Morningstar Credit Ratings, LLC has discerned some notable volatility in prepayment rates among residential property assessed clean energy securitizations we rate. Morningstar has rated both public and private residential PACE securitizations from most major PACE originators. These primarily consist of senior notes and sometimes residual notes, which in the case of the latter, we typically assign low investment grade ratings. The 26 months of data points we have reveal increased volatility and a generally accelerating trend in prepayments. While senior notes typically benefit from higher prepayments, residual noteholders should be aware of this developing trend because these residual notes depend on excess spread to pay down a portion of the principal balance and an acceleration in prepayment curtails the amount of excess spread available for such purpose.

Prepayment Volatility

Since our last [report](#) on this topic, Prepayment Rates Across Residential PACE Are on the Rise, published six months ago, monthly annualized constant prepayment rate averages have been fluctuating between increases and declines. For example, after a decline in the averages for a couple months, prepayments shot back up, only to be followed by a declining trend in the past three months. Amid all this volatility, however, monthly annualized CPR averages continued to remain significantly higher than their single digit start, with averages in double digits.

In addition, we are seeing different prepayment patterns emerge across originators. Over the 26-month period, prepayment rates tended to be higher for originators that did not impose prepayment penalties versus prepayments seen at originators with prepayment penalties. While we don't have a large data set on correlation between prepayment rates and the corresponding penalties, there is some evidence that penalties discourage property owners from prepaying their outstanding PACE obligations. In some cases, an originator may sometimes waive the penalties and put funds aside to cover them.

Future increases in monthly annualized CPR averages could also be attributed to other actions, such as buybacks of select PACE assessments from securitization trusts due to failed eligibility requirements specified in transaction documents. We saw this happen in 2017, when two sharp one-off spikes in monthly annualized CPR occurred after Ygrene Energy Fund, Inc. repurchased PACE non-eligible assets, as disclosed in their SEC filings. This factor is always one to keep an eye on for new originators and relatively new ABS sectors. As the market matures and legal documentation across transactions become more standard, this trend is likely to decline.

It is also possible this year's trend may indicate a more stable prepayment pattern. That would give more credence to the premise that the acceleration in prepayments last year was potentially related to tax reform measures, which now cap the amount of state and local property taxes a homeowner may deduct at \$10,000. In addition, the recent prolonged 35-day government shutdown, might have diminished the ability of some homeowners to prepay PACE assessments because of potentially delayed income and tax refunds. While we do not have definitive statistics on federally employed homeowners who have PACE assessments that were included in securitizations, a delay in payment of bills, receiving pay, or receiving tax refunds may strain their abilities to make timely payments.

The shutdown is worth noting because a sizable number of homeowners were out of work in California, according to the U.S. Office of Personnel Management. For example, the Department of Homeland Security was closed during the shutdown, affecting 22,587 California workers, while the Department of Treasury saw 12,764 of its California workers sidelined. It is yet to be seen if there will be another shutdown after the Feb. 15 deadline. While legislators appear to have reached a tentative agreement to avert a second government shutdown under the current administration, the deal still needs to be signed by Trump.

As we collect more observation points and these long-term PACE assets move further along in the amortization cycle, it will be easier to discern whether this volatility in prepayments is the norm or driven by isolated exogenous factors, such as tax reform or originator repurchases. One thing is certain, amid the volatility, prepayments have remained persistently higher than when we started receiving data. Morningstar will continue to track the volatility in prepayments and any credit impact an acceleration in prepayments may have on the notes we rate.

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