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ABS Research

Clearing the Air—Addressing Three Misconceptions of PACE

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Morningstar Perspective

As financing of energy-efficient projects through property assessments becomes more widespread, concerns and misconceptions regarding its use and oversight have become more common. Morningstar Credit Ratings, LLC explores three misconceptions we have heard from market participants regarding the residential property assessed clean energy sector. First, we note that a PACE assessment is an asset-based obligation, rather than a mortgage loan, so lien-to-value ratio, more than an individual's credit score, is a more appropriate risk indicator. At their core, PACE obligations and mortgage loans are distinct, and PACE assessments should be subject to different credit analysis. Second, we believe that a PACE assessment does not materially increase the risk to the underlying mortgage, even though the total lien-to-value ratio may increase. Lastly, we address the level of industry oversight amid concerns regarding the possibility of inappropriate financing. There are two tiers of oversight, with state and local governments specifying eligible projects and standardizing practices, as well as industry-initiated internal controls aimed at enhancing consumer protections.

Misconception #1: Not Using FICO is Worrisome

Lien-to-value ratio is the key credit-risk consideration, because PACE lending is tied to the asset and not to the creditworthiness of the property owner; thus, leverage ratios are more relevant risk indicators than borrowers' FICO scores. An expectation to see FICO scores in residential PACE eligibility criteria may exist because of the similarities between PACE assessments and mortgage loans.

Indeed, both share the same collateral, the same obligation to pay, and the ultimate consequence of property loss if the contractual obligation is not met. However, a critical difference is that the obligation to pay a PACE assessment remains with the land, not the homeowner.

Originators may consider three types of leverage ratios when underwriting PACE assessments on the property: the PACE lien to the property's market value, annual tax and assessment to the property's market value, and combined mortgage loan and PACE assessment to the property's value. PACE programs generally originate assessments with low leverage ratios, as owners with more equity in their properties have more incentive to pay their obligations. For example, the assets in HERO Funding 2016-4 had a weighted average PACE lien-to-value ratio of 6.68% and a weighted average combined lien-to-value ratio of 62.74%. Combined lien-to-value is the ratio of the mortgage loan and PACE assessment to the property's market value.

The primary risk in PACE securitizations is liquidity. When property owners fail to pay PACE assessments, cash flow to the deal could be disrupted. Liquidity risk is mainly associated with the timing and amount of recoveries. While FICO scores are not part of the underwriting criteria for most PACE programs, major originators collect borrower FICO data. To estimate mortgage defaults in PACE securitizations, Morningstar considers each borrower's FICO score, mortgage balance, and combined lien-to-value ratio, as mortgage defaults may disrupt payments on PACE obligations. Morningstar has not observed any major PACE originators pursuing originations to borrowers with weaker credit. Indeed, borrowers associated with GoodGreen 2016-1 Trust, rated by Morningstar in November, had a weighted average FICO score above 700.

Besides, a FICO score reflects only the current homeowner's creditworthiness, and the score may materially change when property ownership changes. PACE assessments typically have a term of 15 to 30 years, and over that period multiple property owners may be required to make PACE payments because the PACE obligation remains outstanding until paid in full. For this reason, PACE is called an assessment or special tax rather than a loan. When analyzing PACE securitizations, Morningstar assumes each assessment will go through multiple default cycles to address the potential deterioration of a FICO score and the possible liquidity interruptions when property ownership changes. In addition, Morningstar may review historical weighted average lien-to-value ratio and the weighted average FICO score of property owners included in an originator's PACE portfolio to identify any trends and may compare them against those of peer PACE originator portfolios.

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Misconception #2: PACE Sharply Increases Risk to the Underlying Mortgage

While a PACE assessment raises a property's lien-to-value ratio, any increased risk to the underlying mortgage is likely minimal. The PACE assessment is usually small in proportion to the mortgage, and the improvements that PACE finances often enhance the property's value and contribute to cost savings.

While most PACE assessments enjoy priority of payment over the mortgage lender, the magnitude of any loss to the lender is likely to be limited. When a property owner defaults on a PACE payment, only the overdue amount, and not the entire balance, is due. This outstanding delinquent PACE amount has priority of payment over a mortgage loan. As noted, the remaining PACE obligation passes through to the subsequent property owner when a property is sold. In addition, if there is a mortgage on the property, the mortgage servicer is likely to advance PACE payments so the lender can control the disposition of the property to protect its interest.

As mentioned, residential PACE obligations are relatively small compared with mortgage loan balances and home values. For an average PACE assessment of $20,000 with a 15-year original term and an 8.5% interest rate, the PACE payment is roughly $200 per month, which can be similar to the existing monthly property tax payment. The PACE payment is only about 14% of an average monthly mortgage payment of $1,398 for a 30-year mortgage with a balance of $276,000 and a 4.5% interest rate.

While a PACE assessment increases a borrower's debt, Morningstar believes these financed improvements often increase a property's resale value. Moreover, the cost savings from such enhancements can partially offset a homeowner's debt burden. Property owners often achieve cost savings such as lower energy and water bills from PACE-financed improvements and savings from the tax-deductible interest portion of PACE payments.

Misconception #3: Industry Lacks Oversight

Government oversight of PACE programs offers various consumers protections. While private companies administer most PACE programs, local governments typically set guidelines and policies, including eligibility criteria, fee structures, and interest rates. California and Florida, two of only three states that currently offer residential PACE financing, have had courts validate their programs. Morningstar believes that the PACE program's oversight by government authorities and the evolving consumer-disclosure framework will increase transparency and consumer protection. For example, Gov. Jerry Brown signed Assembly Bill 2693 (PACE Preservation and Consumer Protections Act) into California law. The law, effective Jan. 1, 2017, introduced more safeguards, including providing consumers with complete financing terms in advance of signing any documents, full disclosure that an owner

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may be required by the mortgage lender to fully pay off the PACE assessment before refinancing or selling the property, and allowing homeowners to cancel the contract within three business days of signing. Separately, the Department of Energy in November published best practice guidelines for residential PACE programs, which outline procedures for state and local governments as well as originators to follow. Likewise, the guidelines suggest a "more rigorous" approach to protect consumers, including verbal confirmation of PACE terms with property owners.

In addition, the industry has sought to enhance consumer protection. PACENation, the industry association, recommended consumer-protection policies before the PACE Preservation and Consumer Protections Act became law in California. Originators have taken voluntary measures, such as requirement of consumer calls to verify their understanding of the key financing terms, to address consumer-disclosure concerns. Morningstar views government authorities and the industry working together to improve consumer protections as credit positives.

The Federal Housing Finance Agency, the independent regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, has expressed concerns over PACE's supersenior lien position to mortgage loans. It is possible that the FHFA policy of a property being free and clear of any liens other than a Fannie Mae or Freddie Mac mortgage loan to obtain financing may result in an owner having to fully pay the PACE obligation for the prospective buyer to get funding. In Morningstar's view, FHFA's policy has limited impact on the property's marketability, because owners have the option to repay the PACE assessment when selling their properties.

The Department of Housing and Urban Development last year issued a letter offering guidance for financing properties with PACE assessments. Such properties are eligible for financing from the Federal Housing Administration (the agency that insures mortgage loans from approved banks) if certain requirements are met. Financing is considered for properties where the PACE assessment functions in a similar fashion to property taxes and the full PACE obligation cannot have a lien status superior to the mortgage obligation. Under this scenario, the PACE lien is not senior to the mortgage and remains with the property. Future PACE payments need to be escrowed. Home buyers of properties with PACE assessments will be responsible for outstanding balances.

The FHA stated that this guidance will safeguard it from risk. "Lenders must escrow payments for PACE assessment so FHA should never be at risk of losing collateral in a tax sale. FHA is also protected as its appraisal policy requires that appraisals take into account the PACE assessment and the value of the improvements," the FHA wrote in a prepared statement in July 2016.

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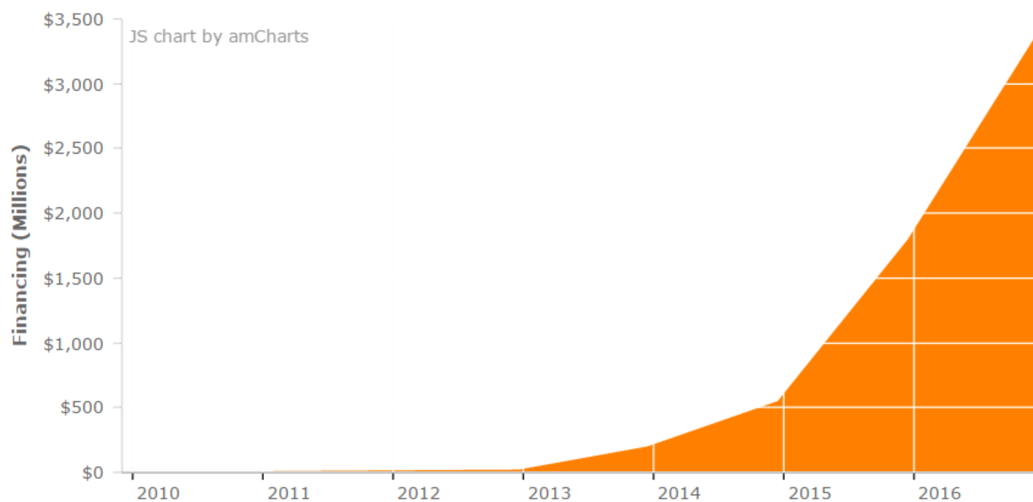
Morningstar views this clarification as a positive development, because it mitigates concerns about having to pay the entire PACE obligation prior to a home sale. Thus, homeowners will be more receptive to making home improvements and enhancements under a PACE program.

Industry Overview

State-run PACE programs are designed to finance improvements that promote energy renewal and energy and water conservation including lighting, heating and air-conditioning improvements, roofing, piping, and solar panels, to name a few. Instead of incuring significant up-front costs, property owners may spread the payments over a longer period, ranging from five to 30 years. According to PACENation, an industry trade group,19 states and Washington D.C. have active commercial programs. Meanwhile, only California, Florida, and Missouri offer residential programs.

Nonetheless, residential PACE financing has skyrocketed over the past few years, with PACENation reporting the cumulative level reaching $3.40 billion at year-end 2016, eclipsing commercial PACE, which totaled approximately $335 million.

Cumulative R-Pace Financing 2010-2016



R-residential
Source: PACENation

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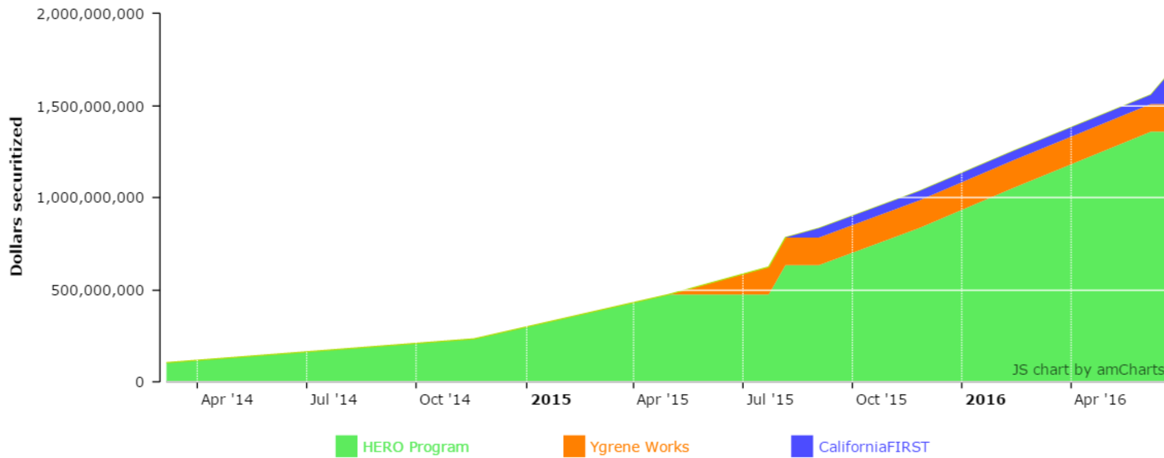
Cumulative R-Pace Dollars Securitized* (By $ Funded)



*Ygrene's securitization included a portion of commercial projects as well as residential projects.
R-residential
Source: PACENation

Originators, including Renovate America, Inc., Ygrene Energy Fund, Inc., and Renew Financial, have sponsored more than $1.57 billion in PACE securitizations in 2016. The growing appetite for PACE bonds is evidenced by Renovate America's successful completion in September of the largest securitization to date, totaling $320.2 million. Morningstar estimates PACE issuance this year will be about $2 billion. The majority of PACE securitizations have comprised residential PACE assessments. However, Ygrene Energy's GoodGreen 2016-1 Trust was the first to contain both residential and commercial PACE assessments, albeit with commercial assessments representing only about 4.8%. The underlying assets were more geographically diverse, as assessments were from California and Florida, whereas other PACE securitizations typically have had assessments from one state. In the Ygrene transaction, California assessments, known as special taxes in the state, accounted for the bulk, at 82.3% of the portfolio, while assets from Florida represented 17.7% . Compared with other securitizations across structured finance, PACE transactions have been more geographically concentrated.

Morningstar views PACE as a beneficial program that offers corporations and consumers the opportunity to affordably implement energy-efficiency and energy-renewable upgrades. In analyzing PACE securitizations, Morningstar considers total leverage a key risk factor, and we believe that a PACE assessment does not materially increase the risk to the underlying mortgage, as energy efficiency improvements should bolster property values and lead to tax and utility savings. As recognition of the nuances in this asset-based obligation becomes widespread, acceptance should fuel future growth.

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