

ABS Research

Prepayment Rates Across Residential PACE Are on the Rise

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Morningstar Perspective

Morningstar Credit Ratings, LLC has identified a trend that may have an effect on the cash flows of property assessed clean energy notes, particularly in the residential sector. Although the R-PACE sector is relatively young compared with its more established brethren in the asset-backed securities market, we have nearly a couple years under our belt and have begun to examine historical data for patterns and trends. Notably, Morningstar has witnessed a steady increase in prepayment rates across all R-PACE originators in Morningstar-rated securitizations. Investors should pay attention to prepayment rates because they can have differing effects on the notes, depending on their position in the capital structure. In general, higher prepayments help to support the senior notes, while they can have a negative effect on the residual certificates which rely on excess spread. Morningstar was the first credit rating agency to assign a AAA rating to an R-PACE securitization, and increasing prepayments bolster our view on the strength of this sector, particularly at the senior note level.

Prepayment Rates on the Upswing

Although there is some volatility in prepayment rates over the roughly 20-month period since the first R-PACE securitization rated by Morningstar was completed in 2016, we have seen an overall increasing trend in constant prepayment rates, with monthly annualized CPR averages rising from single digits to high teens. In certain months, the annualized CPRs are even higher. Thanks to the long-term tenor of PACE assessments and the fact that they have yet to experience a full amortization cycle, there are challenges in discerning whether prepayment rates have peaked and are near stabilizing or if they are going to continue their march upward.

While this CPR trend in R-PACE may be sector-specific, investors should keep in mind that there are a couple possible explanations for it. Tax reform may be a reason behind the acceleration of prepayments as homeowners now have a reduced cap of \$10,000 on state and local property taxes that they can deduct on their tax returns. However, we have yet to see concrete evidence supporting this. If tax reform is indeed the catalyst, it will be interesting to see whether the acceleration in prepayments is limited to 2018, or if the trend will continue. In addition, CPR increases may also be attributed to originators buying back select assessments because of eligibility requirements as mandated by transaction documents. While technically not prepaid by the borrowers, these assessments are bought back from the securitization trust and do not generate excess spread for the transaction anymore; in essence, they behave like prepayments. Morningstar has noted some large one-off spikes in prepayment rates of securitizations of a major originator for similar reasons. While these may be idiosyncratic events, they can add up, especially for smaller or newer originators.

Evolving Landscape

In April, California instituted improved underwriting guidelines following the passage of [Assembly Bill 1284](#) in late 2017. New standards include income verification and assessing the homeowner's ability to pay. The market has seen a decline in new origination volume as the ability-to-pay rules have affected the sector in a couple of ways. The more arduous screenings are resulting in longer processing times and a likely decrease in the number of borrowers who qualify. Homeowners may opt for a quicker and easier financing option, such as a consumer loan.

In addition, we are also seeing increased oversight at the federal level as [Senate Bill 2155](#), also known as the Economic Growth, Regulatory Relief, and Consumer Protection Act, was signed into law on May 24. Under section 307, the Consumer Financial Protection Bureau is directed to apply ability-to-repay regulations to PACE financings, though it's unknown to what extent and when the CFPB will implement such measures. Morningstar views the increasing consumer protections as a positive development in the industry because they will strengthen underwriting practices, leading to improved credit quality of the underlying assessments. At the same time, however, it's likely that we will see a decrease across originations.

This decline in new origination volume may result in originators reducing or eliminating prepayment penalties, in instances where they exist, as they attempt to remain competitive in a shrinking market. If prepayment penalties get waived, this could potentially have a negative effect on the residual certificates. These residual certificates are usually sensitive to high prepayment rates, especially if there are no additional safeguards in place, such as the originator setting aside funds to cover the waived penalties. It's worth noting, though, that we have not yet detected any correlation between prepayment rates and prepayment penalties. Originators themselves are also re-examining their businesses, with some market participants having considered mergers.

As this new asset class matures and goes through a full amortization cycle, we will have a better idea of collateral performance trends. In the meantime, Morningstar will continue to monitor the acceleration in prepayment rates and the corresponding effect on the notes' cash flows.

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