ABS Research

Residential PACE May Become Less Attractive in the Wake of Tax Reform

February 2018

Authors:

Derek Moran | Senior Vice President | derek.moran@morningstar.com | +1 646 560-4561
Phoebe Xu | Senior Vice President | phoebe.xu@morningstar.com | +1 646 560-4562
Jonathan Lam | Senior Vice President | jonathan.lam@morningstar.com | +1 646 560-4581

Analytical Manager:

Brian Grow | Managing Director | brian.grow@morningstar.com | +1 646 560-4513

Morningstar Perspective

Residential property assessed clean energy loans may lose some appeal to homeowners as a financing tool for energy-efficient projects following the recent major tax overhaul, which potentially reduces some of the tax advantages of these loans. Morningstar Credit Ratings, LLC anticipates fewer new PACE loans this year and more prepayments on existing loans, especially among borrowers with higher FICO scores who wish to pay off their debt early. Increased prepayments are typically a credit positive for senior notes, but they can have a negative effect on the residual notes, which are at the bottom of the stack and usually benefit from prolonged cash flows.

Of the many changes ushered in, three stand out:

Mortgage interest deduction lowered. Although the previous limit of $1.0 million still applies to existing homes, anyone taking out a new mortgage from now on will be able to deduct the interest on only the first $750,000 of mortgage debt.

State and local tax deduction limit lowered. Items that were taxed at the state and local level were previously broadly deductible from federal taxes to avoid being taxed twice. Now there is a cap of $10,000 on the amount of state and local taxes that may be deducted from federal taxes.

Standard deduction raised. The standard deduction for a couple filing jointly is $24,000, up from $12,700. The head of household deduction is $18,000, up from $9,350. Individual taxpayers can deduct $12,000, up from $6,350.

Adding up the Effects to Residential PACE

Predicting the effect on PACE is not straightforward and depends on an individual borrower's circumstances; however, many taxpayers who previously chose to itemize their taxes may now find the standard deduction more appealing. The decision will depend on which one is greater, the standard deduction or the total itemized deduction. The Internal Revenue Service does not treat PACE payments as tax payments, but instead as loan installments where only the interest portion is tax deductible. Therefore, if a borrower's state and local tax deduction plus all itemized deductions (including child care expenses, charitable contributions, mortgage interest payments, as well as PACE interest payments) add up to less than the standard deduction, the incentive to itemize is diminished.

The bulk of PACE borrowers are in California, which has some of the highest median home prices in the country. According to the latest data available from the National Association of REALTORS®, the San Jose-Sunnyvale-Santa Clara metropolitan statistical area had the highest median sales price for existing single-family homes, at $1.2 million as of third-quarter 2017, the latest data available. San Francisco-Oakland-Hayward, with a median price of $900,000, and Anaheim-Santa Ana-Irvine, with an average home price of $790,000 as of the same period, were ranked the next highest. These average sales figures indicate that many California borrowers' first mortgage would account for most or all their mortgage interest deduction. Therefore, whatever tax benefit these borrowers enjoyed from their PACE loan, which was already limited to only the interest payments, would be lower.

A Split Market

The market can be partitioned into two segments: borrowers with higher FICO scores and borrowers with lower FICO scores and more limited financing options. Each segment would potentially respond to the tax reform differently.

More creditworthy borrowers sometimes use PACE financing as a bridge loan (Morningstar has seen a trend of higher prepayments for PACE borrowers with higher credit scores). If borrowers' behavior is influenced by tax implications, they are likely to find their existing PACE loans less advantageous. Those who can afford to pay off the PACE loans may choose to do so quickly, leading to increased prepayments. Similarly, new borrowers with other options may select alternative financing for new projects or simply choose not to do the project, leading to lower origination volumes in the higher FICO segments.

Lower-income borrowers with lower FICO scores are likely to have fewer options to refinance or pay off existing PACE assessments, so any increased prepayments in this segment would be more muted. However, this group may also contribute to suppressed origination volumes because of the drop in PACE's tax incentives as a result of the higher standard deductions.

Prepayments: Both Beneficial and Troublesome

From a credit perspective, prepayments are typically positive for senior notes in PACE securitizations and negative for residual notes. These tax reforms appear to be mildly credit positive for the senior notes of existing securitizations since we expect a higher number of assessments to pay off early, leaving a lower number of assessments susceptible to default. Conversely, faster prepayment speeds are credit negative for residual notes because these notes rely on the excess spread to make interest and principal payments. Any assessment that is paid down ahead of schedule is received as principal cash flow to the senior bonds, but that is less cash flow the residual notes potentially could receive.

Re-Evaluating PACE

While it is too early to tell exactly how the new tax laws will affect borrower behavior, Morningstar believes the changes may cause some borrowers to reconsider their PACE funding options, potentially motivating faster prepayments, especially among higher FICO borrowers. In addition, origination could dip a bit as PACE loans become less beneficial from a tax perspective. While senior notes in existing PACE securitizations benefit from more prepayments, they could hurt the residual notes at the bottom of the capital stack, which depend on a steady flow of interest payments from borrowers for a long time. Volatility from prepayments could threaten the health of these notes.