



OLR RESEARCH REPORT

July 10, 2012

2012-R-0291

PROPOSED FEDERAL REGULATION ON PROPERTY ASSESSED CLEAN ENERGY PROGRAMS

By: Kevin E. McCarthy, Principal Analyst

You asked for a summary of the proposed federal [regulations](#) (12 CFR Part 1254) on residential property assessed clean energy (PACE) programs and their potential implications for PACE programs in Connecticut.

SUMMARY

The Federal Housing Finance Agency (FHFA) has jurisdiction over and is acting as conservator of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These two enterprises buy mortgages and account for the bulk of the activity in the secondary residential mortgage market.

On June 15, 2012, FHFA issued a notice of proposed rulemaking concerning underwriting standards of Fannie Mae and Freddie Mac relating to mortgage assets affected by PACE programs. As described in OLR report [2012-R-0178](#), under these programs municipalities can issue loans for energy efficiency and renewable energy improvements. The loans are typically backed by a lien on the affected property, which is generally treated like a property tax lien. In most states, although not Connecticut, this is a first lien that takes priority over existing mortgages.

The notice of proposed rulemaking:

1. reviews FHFA's statutory authority as the regulator of the enterprises and their conservator;
2. summarizes issues relating to PACE that are relevant to its supervision and direction of the enterprises;
3. summarizes comments FHFA received related to PACE and its earlier actions which had effectively ended most residential PACE programs;
4. summarizes FHFA's responses to these comments;
5. presents the proposed rule and alternatives FHFA is considering; and
6. invites comments from the public, which must be submitted by July 30, 2012.

Under the proposed regulations, FHFA would, among other things, bar the enterprises from buying any mortgage that is subject to a first lien PACE obligation or consenting to have such liens placed on existing mortgages that they already own. FHFA is considering three alternative ways to mitigate the financial risks that first-lien PACE programs could pose to the enterprises that would allow them to buy mortgages subject to PACE loans under limited circumstances.

It appears that the proposed regulation would not have any effect in Connecticut under the municipal PACE programs authorized under PA 11-80 (CGS § [7-121a](#)), since the liens associated with PACE loans under these programs do not take priority over existing mortgages. On the other hand, the proposed regulation might affect PACE loans for multi-family housing under the Clean Energy Finance and Investment Authority (CEFIA) program, authorized by PA 12-2, June 12 Special Session, but not the loans authorized by that act for other commercial properties.

PREVIOUS ACTIONS

As discussed in OLR Report [2012-R-0027](#), FHFA has raised three concerns regarding PACE programs. First, it believes that the priority liens established by PACE programs may alter how mortgage-backed securities are valued and pose significant risk to lenders and other entities in the secondary mortgage market. Second, FHFA believes that PACE loans lack adequate consumer protections. Third, it believes that

the programs lack robust underwriting standards to protect homeowners and have inadequate energy retrofit standards.

In August 2010, Fannie Mae and Freddie Mac announced that they would not purchase mortgages originated on or after July 6, 2010 that were secured by properties encumbered by PACE obligations. In February 2011, FHFA's general counsel sent a letter to general counsel for Fannie Mae and Freddie Mac, reaffirming that debts arising from PACE programs pose significant risks to these entities. FHFA directed that Fannie Mae and Freddie Mac continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations. In effect, FHFA's actions precluded mortgages with PACE liens from being sold on the secondary market and stopped the implementation of PACE programs with regard to residential properties in Connecticut and elsewhere.

In response to the federal actions, the state of California and Sonoma County, California and several other jurisdictions sued FHFA, Fannie Mae, and Freddie Mac, seeking declaratory and injunctive relief. They argued, among other things, that the federal entities violated the requirements of the Administrative Procedures Act and the National Environmental Protection Act. The court denied FHFA's motion to dismiss, allowing the suit to proceed. It granted, in part, Sonoma County's motion for a preliminary injunction. It ordered FHFA, without withdrawing its directives to Fannie Mae and Freddie Mac, to proceed with the notice and comment process required by law ([*California v. Federal Housing Finance Agency. et al.*](#), N.D. California, 8/26/2011, 2011 WL 3794942). The proposed regulations are the result of this decision.

PROPOSED REGULATION

Under its proposed regulation, FHFA would:

1. direct the enterprises to immediately take action to secure or preserve their right to make immediately due the full amount of any obligation secured by a mortgage that becomes, without the consent of the mortgage holder, subject to a first-lien PACE obligation;
2. bar the enterprises from buying any mortgage that is subject to a first lien PACE obligation; and
3. prohibit the enterprises from consenting to the imposition of a first-lien PACE obligation on any mortgage in their portfolios.

Under the proposal, a PACE obligation is a financial obligation created under a PACE or similar program to finance energy-related home improvement projects through voluntary or contractual assessments against the underlying property. A first lien PACE obligation (1) has priority ahead of or senior to a first mortgage on the same property or (2) otherwise subordinates the first mortgage holder's security interest to that of another financial obligation secured by the property. The proposed regulation does not address PACE loans where the lien does not take priority over existing mortgages.

PROPOSED ALTERNATIVES

FHFA is considering three alternatives to the proposed regulation. Under the first, the enterprises could consent to new first-lien PACE obligations that are recorded in the relevant jurisdiction's public land-title records if (1) repayment of the mortgage is guaranteed by a qualified insurer, with the guarantee obligation triggered by any foreclosure or other similar default; (2) a qualified insurer insures the enterprises against 100% of any net loss attributable to the PACE obligation in the event of a foreclosure or other similar default or (3) the PACE program itself provides a sufficient reserve fund to protect the holders of mortgage interests on the affected properties.

Under the second alternative, the enterprises could only buy mortgages subject to PACE loans if the:

1. PACE obligation is no more than \$25,000 or 10% of the fair market value of the underlying property, whichever is lower;
2. current combined loan-to-value ratio reflecting all obligations secured by the underlying property, including the PACE obligation, would be no greater than 65% based on a current qualified appraisal;
3. borrower's adequately documented debt-to-income ratio (including service of the PACE obligation) would be no greater than 35% using the calculation method provided in the enterprises' guides;
4. borrower's FICO credit score is not lower than 720; and
5. PACE obligation is recorded in the relevant jurisdiction's public land-title records.

Under the third alternative, the enterprises could only buy mortgages subject to PACE loans if 17 conditions are met. These include that:

1. all property taxes and any other public assessments on the property are current and have been current for three years or the property owner's period of ownership, whichever period is shorter;
2. there are no involuntary liens, such as mechanics liens, on the property in excess of \$1,000;
3. the property owner is current on his or her mortgage and has equity equal to at least 15% of the property's value;
4. the improvement funded by the PACE loan has been the subject of an audit or feasibility study that meets extensive requirements specified in the proposed regulation;
5. the improvement will be made or installed by a contractor determined by the local government to be qualified to make the PACE improvements; and
6. disbursement of funds for the PACE loans are not permitted unless assessments for a property are no more than 10% of its estimated value.

FHFA has expressed reservations regarding all three alternatives.

IMPLICATIONS FOR CONNECTICUT

It appears that the proposed regulations would not affect residential PACE loans in Connecticut entered into under PA 11-80, since the regulations apply specifically to PACE loans where the liens backing the loans take priority over existing mortgages. In contrast, CGS § [7-121a](#) provides

Assessments levied pursuant to this section and the interest and any penalties thereon shall constitute a lien against the qualifying real property on which they are made until they are paid. Such lien shall be levied and collected in the same manner as the general taxes of the municipality on real property, including, in the event of default or delinquency, with respect to any penalties and remedies and lien priorities, *provided such lien shall not have priority over any prior mortgages.* (emphasis added)

In contrast, the PACE program authorized by PA 12-2, June 12 Special Session does provide for first-lien PACE loans. The act (1)

requires CEFIA to establish a separate PACE program for qualifying commercial property (including multifamily buildings with five or more units) and (2) allows municipalities to participate in this program under a written agreement approved by their legislative bodies. Unlike the programs authorized by PA 11-80, this act gives the PACE lien priority over existing mortgages, although it requires that the property owner give existing mortgage holders at least 30 days' written notice of his or her intent to participate in the program before the lien is recorded.

Neither Fannie Mae or Freddie Mac buys mortgages for business properties and Fannie Mae only buys residential mortgages for properties with up to four units. But Freddie Mac buys mortgages for larger residential properties. If the proposed FHFA regulations are adopted, they could affect the owners of these properties who wish to participate in the program authorized by PA 12-2, June 12 Special Session by limiting or precluding the sale of mortgages on properties on the secondary mortgage market.

KM:ro