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Securitization of Renewable Energy Loans

Renewable energy sources have increasingly become a focal point of U.S. regulatory and financial institutions as well as trade associations and legislatures. One main source of interest in this regard is programs that have been established by local and state governments to encourage homeowners to become more energy efficient through the use of Property Assessed Clean Energy ("PACE") loans. PACE loan programs are designed to make it cheaper for homeowners to install solar panels or other energy improvements in their homes. Under these programs, which have been adopted in a number of states, local municipalities borrow money through the issuance of bonds and use the proceeds of the bond offering to make loans to homeowners to cover the upfront costs of energy efficiency improvements to their homes. The programs are voluntary, and each homeowner agrees to repay the loan over a period of up to 20 years through a special property tax assessment which attaches to the property. PACE loans were pioneered in Berkeley, California in 2008,[1] and the liens securing PACE loans are normally senior to mortgages.

PACE loans and other renewable energy financial assets could be monetized through securitization. In securitizing these assets, a private company would act as the sponsor of the related securitization by aggregating PACE loans acquired from municipalities, engaging a loan servicer and then, ultimately, segregating the aggregated PACE loans into discrete pools of assets. Notes secured by the receivables from those pools would be marketed to third party investors. This *Dechert OnPoint* discusses some of the considerations that should be taken into account when securitizing PACE loans and the industry-related discourse regarding these issues.

Regulatory and Legislative Action

In the past, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac," and together with Fannie Mae, the "GSEs") have raised concerns regarding PACE loan programs. In letters sent to mortgage lenders on May 5, 2010, Fannie Mae and Freddie Mac stated that PACE loan liens could not take priority over a mortgage.[2] On July 6, 2010, the Federal Housing Finance Agency ("FHFA"), the conservator of Fannie Mae and Freddie Mac, in a release regarding PACE loan programs stated that "[u]nder most of these programs, such loans acquire a priority lien over existing mortgages . . . [and] . . . [f]irst liens established by PACE loans are unlike routine tax assessments and pose unusual and difficult risk management challenges for lenders, servicers and mortgage investors."[3] The FHFA added that "first liens for such loans represent a key alteration of traditional mortgage lending practice. They present significant risk to lenders and secondary market entities, may alter valuations for mortgage-backed securities and are not essential for successful programs to spur energy conservation."[4] The FHFA directed the GSEs to: (i) waive their

1 "*Loan Giants Threaten Energy-Efficiency Programs*," New York Times, June 30, 2010.

2 Id.

3 FHFA, "*FHFA Statement on Certain Energy Retrofit Loan Programs*," July 6, 2010

4 Id.

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mortgage loan prohibitions against such senior liens for any homeowner who obtained a PACE loan with a priority first lien before the date of the FHFA release; (ii) adjust loan-to-value ratios to reflect the maximum permissible PACE loan amount available to borrowers in PACE program jurisdictions; (iii) ensure that loan covenants require approval or consent for any PACE loan; (iv) tighten borrower debt-to-income ratios to account for additional obligations associated with possible future PACE loans; and (v) ensure that mortgages on properties in a jurisdiction offering PACE-like programs satisfy all applicable federal and state lending regulations and guidance.[5] On February 28, 2011, the FHFA issued a letter directive, which reiterated that PACE liens present significant risk to certain assets and property of GSEs and as such, GSEs should continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations.[6]

Likely in response to the concerns raised by FHFA in their earlier press release and directive, on July 20, 2011, H.R. 2599 or the "PACE Assessment Protection Act of 2011" was introduced in the U.S. House of Representatives (the "Bill").[7] The Bill is designed to prevent Fannie Mae and Freddie Mac from adopting policies that contravene established state and local PACE programs. The Bill directs Fannie Mae and Freddie Mac to issue guidance that the levy of a PACE assessment and the creation of a PACE lien do not constitute a default under any loan secured by an instrument of Fannie Mae or Freddie Mac or trigger the exercise of remedies under any such instrument. A PACE loan shall be entitled to the protections of the Bill if, among other things: (i) the property owner agrees in writing to a PACE assessment and agrees to a payment schedule that identifies the term over which PACE assessment installments will be due, the frequency with which PACE assessments will be billed and the amount of each installment and the annual amount due on the PACE assessment; (ii) the local government discloses to the participating property owner the costs and risks associated with participating in the PACE program; and (iii) the property owner or the local government provides prior written notice of the terms of the PACE assessment to the holders of any existing mortgages on the property. The Bill further provides that a qualifying PACE program shall provide for the following: (i) PACE improvements shall be financed on terms such that the total energy and water savings realized by the property owner and his or her successors during the useful lives of the improvements, as determined by an audit, are expected to exceed the total cost to the property owner and his or her successors of the PACE assessments; (ii) the total amount of the PACE assessments for a property shall not exceed 10 percent of the estimated value of the property; (iii) as of the effective date of the PACE agreement, the property owner shall have equity in the property of not less than 15 percent of the "estimated value" of the property (calculated without including the amount of the PACE assessment or the value of the PACE improvements); and (iv) the maximum term of the financing provided for a PACE improvement is not more than 20 years. There has been no activity regarding the Bill since August 22, 2011, when it was referred to the Subcommittee on Insurance, Housing and Community Opportunity of the House Committee on Financial Services.

More recently, in response to a California federal district court order issuing a preliminary injunction until such time as the FHFA proceeded with the notice and comment process in adopting guidance concerning mortgages that are or could be affected by PACE programs, in March 2012, the FHFA issued an advance notice of proposed rulemaking on "Mortgages Affected by PACE Programs" (the "PACE ANPR").[8] In the PACE ANPR, the FHFA has proposed three alternatives for which it has sought comment. The first alternative would be for the FHFA to direct GSEs not to purchase any mortgage that is subject to a first-lien PACE obligation or that could become subject to first-lien PACE obligations without the consent of the mortgage holder. The second alternative would be for the FHFA to withdraw its July 2010 statement and February 2011 directive and permit GSEs to purchase mortgage loans secured by properties with outstanding first-lien PACE obligations. Finally, the FHFA invited comments on other reasonable alternatives that permit mortgage loans on properties encumbered by PACE loans to be purchased by GSEs while minimizing the risk to such entities.

On March 26, 2012, the Mortgage Bankers Association, American Bankers Association, Community Mortgage Banking Project, the Consumer Mortgage Coalition, the Housing Policy Council and the Independent Community Bankers of America submitted a comment letter in response to the PACE ANPR outlining several issues for

5 Id.

6 FHFA, *Mortgage Assets Affected by PACE Programs*, 12 CFR Part 1254, RIN 2590–AA53.

7 The Bill was introduced by Representative Hayworth (R-N.Y.) and was referred to the House Committee on Financial Services. The Bill has 51 co-sponsors (30 Democrats and 21 Republicans).

8 *Supra* at fn. 6.

consideration by the FHFA.[9] In particular, these trade associations expressed concerns regarding the purchase of loans by GSEs, which were encumbered by, or could become encumbered by, a PACE lien under the rationale that the GSEs were created to promote stability and liquidity in the secondary mortgage market and PACE liens with priority over mortgages may pose potential risks (such as increased severity of loss to a mortgage holder and increased mortgage default rates) that are inconsistent with the GSEs' mandate.

Issues Relating to the Securitization of PACE Loans

In the context of the regulatory and legislative action in this area, there are several issues that must be considered in the securitization of PACE loans. First, while the objections of the FHFA and the trade associations call into question whether there will be significant amounts of PACE loans available to aggregate and then securitize in the immediate future, several energy efficiency companies have suggested that they have received strong indications that these types of financing programs have and will continue to develop sufficient interest from homeowners.[10] Nonetheless, given the concerns of the FHFA and trade associations, the industry may find that securitization of renewable energy loans relating to commercial properties may proceed at a quicker pace than the securitization of PACE loans relating to residential properties.

Another potential issue for securitization of PACE loans is the creditworthiness of the municipalities making the PACE loans. The tax assessment relating to PACE improvements is paid by the homeowner directly to the related local government. These funds are held by the related local government until they are paid to investors in PACE bonds. The time period until the funds are paid to investors can last up to a few months. As such, the availability of the funds to make payment on the PACE bonds may rely to some extent on the protocols and standard operating procedures for management of funds because of the length of time each such government would need to remain in possession of the related funds.

Yet another issue for potential investors in bonds backed by PACE loans is the lack of historical data regarding default experience, foreclosure experience and other factors. This information is typically required by rating agencies in connection with each transaction they rate. PACE loans are a relatively new financial asset and, thus, there is not much historical data regarding default experience with PACE loans. Rating agencies are likely to require more historical data. Additionally, in structuring transactions involving PACE loans, the relatively quickly pace in which PACE loans are paid down should be considered. One approach to ensuring that there are sufficient cash flows for the duration of the time payments would be made on PACE loan-backed bonds is to maintain adequate overcollateralization.

Finally, the availability of successor servicers in the event the primary servicer of the PACE loans is unable to adequately service the PACE loans may prove to be another potential issue. It is not clear whether there would be many potential successor servicers who would be interested in taking on this role for this asset type. This situation could affect any potential rating of a securitization of PACE loans.

Conclusion

Although renewable energy financial assets, such as PACE loans, have yet to be securitized to any significant degree, increasing interest indicates that PACE loans may prove to be a potential new asset type that is ripe for securitization.

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9 Mortgage Bankers Association, American Bankers Association, Community Mortgage Banking Project, Consumer Mortgage Coalition, Housing Policy Council and the Independent Community Bankers of America, Letter re: *Advance Notice of Proposed Rulemaking Mortgage Assets Affected by PACE Programs (RIN) 2590-AA53, dated March 26, 201[2].*

10 Diane Cardwell, Solar Installers Offer Deals, Gaining Converts, New York Times, May 9, 2012.

Contacts

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