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Consumer Protection Remains at the Forefront for Residential PACE; Commercial PACE Gains Momentum

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Authors:

Stephanie K. Mah | Director of Strategy and Research | stephanie.mah@morningstar.com | +1 646 560-4571
Phoebe Xu | Senior Vice President | phoebe.xu@morningstar.com | +1 646 560-4562

Analytical Manager:

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

Morningstar Perspective

As we head into 2018, Morningstar Credit Ratings, LLC expects that consumer protections will continue to be a focal point for residential property assessed clean energy bonds. Indeed, the U.S. Department of Housing and Urban Development recently reversed course, stating that the Federal Housing Administration will no longer insure mortgages on properties with PACE assessments. This could affect the ability of property owners with PACE assessments to refinance their already FHA-insured mortgages. Ultimately, however, Morningstar believes that focusing on consumer protections is good for the industry and a credit positive for the quality of the underwriting. This year, Morningstar rated six PACE securitizations, and all but one was composed mostly of residential assessments. The first PACE securitization with only commercial assessments was completed in September, and securitized residual interest notes became more common this year. While we expect more commercial PACE transactions in 2018, residual interest note issuance may retreat if market conditions make it less economical, such as less excess spread being available.

PACE Consumer Protections Strengthen, but HUD Reverses Course

PACE programs offering financing for renewable energy, energy efficiency, and wind/storm resistance upgrades to private residences and commercial properties have been around since 2007, but the securitization market for these assets dates back only three years. Approximately $1.50 billion in residential PACE securitizations have come to market in the first 11 months of this year, according to PACENation, an industry trade group. As this nascent asset class continues to develop, there have been some growing pains as governmental agencies scrutinize lending practices.

In a reversal from its earlier decision, HUD published a letter on Dec. 7, 2017, indicating that properties with PACE obligations would no longer be eligible for FHA-insured financing. The policy change goes into effect 30 days from the publish date. The FHA cited concerns about the priority lien status afforded to PACE assessments over mortgages and the lack of consumer protections associated with such obligations. This development could potentially increase prepayment speeds of assessments underlying PACE securitizations if a property owner with an existing FHA mortgage seeks to refinance or sell. While refinancing will likely be less of a concern in a rising-interest-rate environment, in a refinance or sell scenario, the property owner would need to pay off the PACE obligation in full to maintain FHA financing or enable the buyer to take out an FHA mortgage loan. The FHA and Federal Housing Finance Agency policies are now aligned, as the FHFA adopted this same policy in 2010, choosing not to insure mortgages with existing PACE obligations.

Therefore, it's not surprising that consumer advocacy remains at the forefront for residential PACE, and originators have been taking steps to address concerns. In some instances, originators have allowed modifications to the original terms of a PACE assessment, including changes to the coupon rate, term, and outstanding balance, as well as prepayment penalties. However, bond investors should scrutinize such modifications, as they can have an impact on the composition of the underlying asset pool. To alleviate concerns, originators may contribute an amount equal to the modification before modifying the loan, to ensure an uninterrupted cash flow.

State and local governments have also put consumer safeguards into place. For example, in California, Gov. Jerry Brown recently signed into law two bills: SB 242 and AB1284. The legislation requires program administrators to make an oral confirmation with property owners on the key terms of an assessment contract. In addition, it also enhances PACE underwriting standards, including income verification and the ability to repay.

Similarly, at the federal level, Sen. Mike Crapo of Idaho recently introduced the Economic Growth, Regulatory Relief and Consumer Protection Act of 2017, proposing that the Truth in Lending Act of 1968 be revised to include PACE obligations. The Truth in Lending Act currently applies to debt such as credit cards and mortgages, but does not consider tax liens or assessments. The bill is progressing as the Senate Banking Committee announced its support in a press release on Dec. 5, 2017.

The Crapo bill is not as onerous as the Protecting Americans from Credit Entanglements Act of 2017, which was introduced by Sen. Tom Cotton of Arkansas earlier in the year. The Cotton bill is considered more restrictive as it would not only require factoring in consumers' ability to repay, like the bill proposed by Crapo, but it would also make it more burdensome for local governments to participate in the PACE program, with potential modifications to their assessment collection procedures or even requiring governments to register as a mortgage lender. Morningstar views these legislative developments as credit positive because they help ensure consumers are aware of their PACE obligation and strengthen underwriting practices.

Residual Interest Notes Become More Common

Another development has been the securitization of the residual interest piece, which represents any proceeds left once all other obligations are paid off, including the senior notes. A sole originator first securitized the residual piece in 2016, and this year other market participants joined in. Morningstar's ratings on residual notes can vary based on the structure, with some addressing the ability to pay ultimate principal and ultimate accrued and unpaid interest by the scheduled maturity date under various rating scenarios, while we may analyze others by examining timely payment of interest and ultimate payment of principal.

The residual note is subordinate to the senior notes and expenses in receiving payment. In addition, the initial overcollateralization amount to the residual notes is negative. As a result, these notes rely significantly on the excess spread in the transaction to pay out, with prepayment scenarios heavily factored in. In some instances, the issuer retained a portion of the residual tranche, giving it some skin in the game and aligning its interests with those of investors. However, higher credit borrowers tend to have more financing options and may prepay faster, which would shorten the life, reduce the residual amount, and potentially hurt the residual bonds.

Nonetheless, we may not see residual notes as frequently in future PACE transactions because increased competition in the sector may result in lower coupons and thus less excess spread. Morningstar has already witnessed a lower coupon rate in a recent PACE deal. Excess spread will likely narrow in 2018, meaning issuing a residual tranche will become less economical for the issuer.

First Commercial PACE Securitization Issued

This year, the first commercial PACE securitization came to market. While commercial assets have been included in previous securitizations, albeit in relatively small proportions, Greenworks Lending's private offering in September marked the first deal with 100% of the underlying assets composed of commercial PACE assessments. In addition to more commercial PACE deals coming to market, Morningstar expects continued activity on the residential side as well. Overall growth in PACE programs will be fueled by energy-efficient, energy-renewal, and water-conservation upgrades, as well as improvements to mitigate for seismic damage, flooding, and wind resilience as natural disasters occur in increasing frequency. Indeed, the aftereffects of Hurricane Irma may increase demand for PACE, allowing property owners to make disaster-resistant improvements to their properties.

Sunny Outlook

Despite increased concerns over consumer protections, Morningstar believes recent initiatives aimed at improving such safeguards will help improve underwriting practices and result in a healthier industry overall for residential PACE. Commercial PACE securitizations appeared this year, and residual interest securitizations gained ground as well, but we expect to see only more commercial PACE transactions in the coming year. Excess spread will likely drop, though, as coupon rates decline, whereas commercial PACE appears to be gaining momentum.