<u>Via Electronic Submission</u>

March 16, 2020

The Honorable Mark Calabria
Director
Federal Housing Finance Agency
400 7th Street SW, 8th Floor
Washington, D.C. 20219

Re: PACE Request for Input, Notice No. 2020-N-1

Dear Director Calabria:

PennyMac[1] appreciates the opportunity to provide feedback on the Federal Housing Finance Agency's (FHFA) request for input regarding the impact of Property Assessed Clean Energy (PACE) programs on Fannie Mae, Freddie Mac (the Enterprises) and the Federal Home Loan Banks (FHLB). We share in FHFA's concerns with PACE programs, especially as it relates to potential consumer harm as well as harm to the Enterprises and by extension, taxpayers. The terms of PACE loans are confusing to borrowers and the product is frequently marketed as not being a loan at all, rather a tax that will "pay for itself." In fact, PACE loans are mortgages that are structured and marketed in a way that allows them to avoid the existing protections afforded to borrowers and investors in traditional mortgage transactions. Therefore we find it prudent for FHFA to consider input received from mortgage participants and take appropriate action to protect consumers, lenders, servicers and investors alike.

[1] Refers to PennyMac Financial Services, Inc. (NYSE: PFSI) and PennyMac Mortgage Investment Trust (NYSE:PMT). PFSI is a publicly-listed specialty financial services firm with a comprehensive mortgage platform that is primarily focused on the production and servicing of U.S. residential mortgage loans and the management of investments related to the U.S. mortgage market. With over 4,200 employees, PFSI operates the largest correspondent aggregator and the sixth largest servicer with over 1.8 million customers, and manages approximately $2.5 billion in assets under management. PMT is a publicly-listed mortgage REIT that invests in unique residential mortgage strategies made possible through the operational and investment management capabilities of its manager and service provider, PFSI. These investments primarily consist of organic investments in credit risk transfer securities and mortgage servicing rights sourced from loans acquired through its leading correspondent production channel.

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PennyMac supports the policy objectives that PACE programs seek to accomplish and we are proponents of sensible financing options that make energy efficient upgrades more accessible to homeowners. At PennyMac, we seek to operate our facilities in an environmentally sustainable manner which manages our impact on the environment by investing in sustainable products and services, committing to increased waste recycling, focusing on energy efficiency and engaging in conservative water consumption practices. While we appreciate the mission that PACE sets out to achieve, we find the programs to be problematic. Accordingly, we concur with FHFA that mitigation strategies need to be devised but believe some of the suggestions put forth attempt to address the issue too broadly and would adversely affect low to moderate income borrowers by making traditional mortgage financing unattainable for them.

<u>Concerns with PACE</u>

Because PACE loans are secured via a special tax assessment on the property, they are given priority lien status over all other existing and subsequent non-tax liens. This allows the PACE lender to foreclose on the property in the event of a default on the assessment and ensures that foreclosure sale proceeds are used to pay delinquent PACE assessments before any other non-tax liens. In practice, however, a PACE default would rarely result in foreclosure as PACE lenders get de facto surety from servicers of first lien mortgages who are obligated to advance the delinquent assessments to protect their investors' security interests.

The novelty of the repayment structure has another consequence as well; it allows PACE lenders to circumvent the myriad consumer protection regulations that govern traditional mortgage financing. For example, PACE lenders are not currently required to adhere to any federal "ability-to-repay" (ATR) requirements. This exemption, combined with the aforementioned free credit enhancement received from first mortgage lien servicers, gives PACE lenders little incentive to implement sound underwriting requirements as they are only truly at risk when lending on properties owned free and clear. In fact, where state regulations still allow, PACE lenders generally underwrite loans based on the value of the collateral alone, without consideration for the borrower's ability to repay the loan—an underwriting practice that played a significant role in the 2008 financial crisis. Currently, only California has state-mandated ATR requirements. PACE lenders use favorable delinquency ratios from their portfolios, though, to support arguments that the default risk on PACE loans is de minimis. Again, such statistics are

skewed by the presence of the first mortgage servicer backstop that exists in most instances, and by the fact that most PACE lending has occurred from 2012 onward, a period of falling unemployment, strong house price appreciation[2] and general economic expansion. The fact that PACE lenders are not experiencing losses is not a reflection of prudent underwriting standards. Rather, it is a byproduct of the program's repayment structure that shifts losses associated with default risk to other parties as well as favorable market conditions.

We applaud lawmakers' bipartisan support and passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)[3] that amends the Truth in Lending Act (TILA) to address PACE financing. We look forward to the Consumer Financial Protection Bureau's (CFPB) Notice of Proposed Rulemaking that will define how ATR requirements will be implemented with respect to PACE loans. It is disconcerting, however, to see such strident opposition to ATR rules from PACE lenders. In their responses to the CFPB's original request for information, PACE lenders pointed to California's implementation of ATR rules as a regulatory failure because it resulted in a significant decline in borrower eligibility following implementation.[4] Given that the rules are not overly-rigorous and allow for broad subjectivity in determining what constitutes an acceptable level of income given a borrower's debt load, we believe the decline speaks to the lack of prudent underwriting standards used prior to the rules' implementation rather than overregulation.

Proponents of PACE financing argue that the lien-priming attribute is necessary in order to attract private capital. However, there is no lack of affordable funding options for energy efficient upgrades. Traditional mortgage financing options can achieve the same objectives as PACE loans but in a highly regulated environment that provides for ample consumer protections. PACE lenders frequently compare themselves—favorably—to unsecured financing, citing lower, fixed interest rates, longer loan terms and easier qualification. While it is true that most providers of unsecured financing would struggle to compete, PACE is *not* unsecured financing. PACE is financing secured by real property, like a mortgage. In this arena, PACE is much less competitive. Traditional mortgage financing, including both Home Equity Lines of Credit

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[2] PACENation. (n.d.). *PACE Market Data.* Retrieved from https://pacenation.org/pace-market-data/ on March 9, 2020

[3] Economic Growth, Regulatory Relief, and Consumer Protection Act, S. 2155, 115th Cong. (2018)

[4] Lazerson, J. (2019, April 11). Energy loans plunge in California after income-qualifying laws took effect. *The Orange County Register*, Retrieved from https://www.ocregister.com/2019/04/11/energy-loans-plunge-in-calif-after-income-qualifying-laws-took-effect/

and Cash Out Refinances typically allow for lower interest rates than PACE and offer terms up to 30 years, the latter offering a fixed rate as well. In the mortgage financing market, the only advantage that PACE programs have is easier credit qualification. However, the CFPB's determination of ATR standards will likely level the playing field with respect to qualification as well.

Recommendations

To the extent it is able, FHFA should promote traditional mortgage financing offered by FHA and the Enterprises with an emphasis on those programs that appropriately balance the unique need for energy efficient upgrade funding with potential risk to taxpayers.

In addition to traditional mortgage financing, there are a number of other programs available to homeowners who seek to lower energy costs by making energy efficient upgrades. One such program is the Weatherization Assistance Program (WAP) for which the Department of Energy estimates as many as 20-30 million U.S. families would qualify.[5] The program, available to low-income families, provides funding for free weatherization services which can include a wide range of upgrades including but not limited to replacement of appliances, replacement or repair of doors and windows, and even the installation of rooftop photovoltaic solar panels in some circumstances. Further, WAP requires the completion of an "energy audit" to ensure that cost savings will exceed the cost of upgrades. PACE lending draws frequent criticism for failing to establish a clear criteria for ensuring that the cost of upgrades and financing do not exceed their benefit.

Alternatives aside, if PACE lending is to thrive in coexistence with traditional mortgage financing, FHFA must come to terms on a reasonable structure that mitigates the inherent risks with the lien-priming aspect of PACE loans. We suggest that FHFA work with the states that have PACE-enabling legislation to mitigate the risks at the source. Some suggestions would be to encourage development of a suitable subordination agreement, or indemnity reserve.

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[5] Office of Energy Efficient & Renewable Energy. (n.d.). *Where to Apply for Weatherization Assistance.* Retrieved from Department of Energy:
https://energy.gov/eere/wipo/where-apply-weatherization-assistance

Some PACE programs offer borrowers a limited subordination agreement if requested by their mortgage lender. We do not interpret the terms of the agreement to be sufficient for meeting the eligibility requirements set forth by the Enterprises and therefore do not accept it as a substitute for lien removal. FHFA should consider working with the state governments and PACE administrators to develop a subordination agreement that is sufficient to meet the Enterprises' eligibility requirements.

In 2013, the State of California funded a $10,000,000 PACE loss reserve whose purpose is to cover "(1) PACE assessments paid while a first mortgage lender is in possession of the property during a foreclosure, and (2) losses incurred by a first mortgage lender resulting from PACE assessments being paid before the outstanding balance in a forced sale."[6] No claims have been made against the reserve since its inception. Unfortunately, while the stated purpose is the indemnification of first mortgage lien holders, only PACE administrators can file a claim, which may be the reason the reserve has gone untouched.[7] FHFA should consider working with the state governments and PACE administrators to develop a single indemnity fund and clear claims process that is deemed sufficient by FHFA to mitigate the Enterprises' risk. Such a reserve could be funded by risk-based mortgage insurance premiums, that would be included in the PACE payments and collected by the tax authorities, and potentially be managed and governed by a federal housing authority. It will be important to consider that thus far, PACE financing has largely transpired during a period of growth in housing prices, falling unemployment, and economic expansion. An effective indemnity reserve would need to account for loan performance through all segments of the economic cycle, including those with declining home prices and high unemployment. In addition, unlike the existing reserve in California, if PACE assessments were to remain in first lien position, the reserve would need to be claimable by the owner of the first mortgage lien.

<u>Feedback on FHFA's Specific Questions</u>

Should FHFA direct the Enterprises to decrease loan-to-value ratios for all new loan purchases in states or in communities where PACE loans are available? By how much should available loan-to-value ratios be reduced to address the increased risk of such

[6] California Alternate Energy and Advanced Transportation Financing Authority (n.d.). CAEATFA PACE FAQ. Retrieved from California State Treasurer: https://www.treasurer.ca.gov/caeatfa/pace/faq.asp
[7] 4 CCR § 10083: https://www.treasurer.ca.gov/caeatfa/pace/regulations/regulations.pdf

liens being placed on the property and what related implications would result from such actions? Should loan-to-value (LTV) ratios be reduced for all loan purchases sufficient to take into account the maximum amount of a PACE financing available in that community? Should potential future increases in permitted percentage of available PACE financing-to-assessed value be considered?

We do not believe that geographic redlining should be used to reduce loan-to-value ratios for two reasons.

First, the size of the affected geographic areas would be too large and not necessarily commensurate with the *volume* of PACE financing being originated in those areas. The special assessment districts that are created to make PACE funding available in a given area are not necessarily delineated by county or city boundaries, making administration of an intrastate geographic overlay difficult, especially as new districts are formed. Thus, the proposed reduction would likely need to be implemented statewide. Further, while only California, Florida and Missouri *currently* have active residential PACE programs, an additional 33 states plus the District of Columbia already have legislation in place that allows for the formation of new PACE assessment districts and programs. This opens the door to an even larger geographic area making the proposed solution untenable.

Second, the implementation of stricter LTVs in certain geographic regions would have a disproportionate effect on both first-time and low to moderate income buyers. In 2019, the median down payment for first-time homebuyers was 6% compared to 16% for repeat buyers.[8] Any reduction to eligible LTV will require more upfront equity from buyers that are already pressed to come up with down payments sufficient to secure financing. In 2019, an individual making the median income in Los Angeles, California would have to save for 43 years in order to accrue a 20% down payment on a median priced home. In Miami, Florida it would take 36 years and in Kansas City, Missouri, 12 years.[9] Even a modest increase to the level of down payment required would have a significant impact on affordability.

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[8] National Association of Realtors®. (2019, November 7). *Families Using Creativity When Buying, Selling Homes: 2019 Buyer and Seller Survey.* Retrieved from National Association of Realtors®: https://www.nar.realtor/newsroom/families-using-creativity-when-buying-selling-homes-2019-buyer-and-seller-survey

[9] Unison (2019). *Home Affordability Report.* Retrieved from Unison: https://contentimages.o-prod.unison.com/images/downloads/Unison_Affordability-Report_2019.pdf

Should FHFA direct the Enterprises to increase their Loan Level Price Adjustments (LLPAs) or require other credit enhancements for mortgage loans or re-financings in communities with available PACE financing? What increased levels would be appropriate for such LLPAs in light of the risks of PACE financing posed to the Enterprises?

As with geographically constricted LTV limits, LLPA increases will make financing more expensive and sometimes unattainable for borrowers who may have no intent to ever seek PACE financing but happen to live in one of the many states that has PACE -enabling legislation. In reality, most homeowners in PACE-eligible areas most homeowners in PACE-eligible areas will never obtain PACE financing. The cost associated with mitigating PACE financing risks should not be subsidized by this majority.

How might the Enterprises best gather or receive information on their existing guaranteed or owned mortgage loan portfolios to understand which loans have PACE liens and in what amount? Should mortgage loan servicers be required to gather and report such information to the Enterprises on a periodic basis? What would the costs and implications be of such a requirement?

We believe that the onus of providing property-level assessment data should be on the taxing authorities within the states that allow PACE financing. The data would be more easily consolidated than if dispersed among hundreds of servicers. Further, servicers' processes and systems are not necessarily optimized to collect and flag supplemental assessments that are created post-origination as many servicers pay taxes electronically and do not receive individual breakdowns or supplemental tax bills at all.

Would it be most effective for states that authorize PACE programs to require a registry of PACE lending so that information currently only held by PACE vendors or local tax rolls could be available and maintained on an ongoing basis? What data should be included in such a registry? What access would be permitted while protecting consumer privacy? Should a federal agency provide for such a registry? What minimum information would be available to allow credit reporting agencies to include PACE obligations in credit reports obtained in connection with mortgage origination or servicing?

We support the creation of a national, rather than state, PACE registry to ensure consistency of data and access. Tax authorities in PACE jurisdictions should contribute to the registry and the information should be made available to mortgage originators and servicers pursuant to existing state and federal privacy laws. The state of California already collects the following data points from PACE administrators semi-annually: (1) Assessor's Parcel Number, (2) Principal Amount, (3) Annual Assessment Amount, and (4) Term.

While we believe that PACE loans should be considered mortgages and be reported and accounted for as such, if PACE is to remain assessment-based, then including the obligation on the borrower's credit report may introduce the risk of double-counting the liability.

Should servicers of mortgage loans for the Enterprises provide an annual or more frequent notice to existing borrowers in PACE-eligible communities informing them that, under the terms of their mortgage, PACE liens are not permitted? Should borrowers be informed of the difficulties that may arise in selling or refinancing their home when a PACE lien has been placed on their property? What other information, if any, should be provided by servicers to borrowers with regard to PACE liens? Should borrowers in PACE jurisdictions be required to execute any additional agreements or certifications in connection with mortgages for the Enterprises, Home Loan Banks or FHA guaranteeing the borrowers will not accept PACE financing for energy efficiency improvements?

We agree that borrowers should be informed about the difficulties that will arise in seeking financing if their property is used to secure a PACE loan. However, a requirement for providing such a notice would be misplaced with mortgage servicers. Rather, borrowers need to be informed by the PACE lender at the time their PACE application is taken. In fact, borrowers with mortgages should be advised that they must contact their servicer to inquire as to whether the terms of their current mortgage allow them to encumber the property with a PACE assessment.

The Security Instruments used in all three states with active PACE programs contain a provision in the "Charges; Liens" section wherein the borrower agrees to "promptly discharge any lien which has priority over [the] Security Instrument." While this specifically addresses the issue at hand, it is buried in a 16 page document that borrowers are very unlikely to read closely at closing. However, were this to also be included in a discrete disclosure specific to PACE loans, there is a much better chance

that it would act as an effective deterrent. Such a disclosure should adequately describe PACE lending so that it is easily understood and can be subsequently recalled by the borrower in the future, and should include names of specific state programs that may or may not use the term “PACE” in their marketing. One example would be the Home Energy Renovation Opportunity (HERO) program available in California and Missouri.

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Thank you in advance for your consideration of these comments. Should you have any questions or wish to discuss further, please contact Oliver Rubinstein, SVP of Product Strategy & External Relations, at (818) 746-2055 and oliver.rubinstein@pnmac.com.

Sincerely,

David Spector
President & Chief Executive Officer
PennyMac Financial Services, Inc.
PennyMac Mortgage Investment Trust