July 30, 2012

VIA EMAIL

Mr. Alfred Pollard
General Counsel
Federal Housing Finance Agency
Attn: RIN 2590-AA53
400 Seventh St N.W., Eighth floor
Washington, DC 20024

Re: RIN 2590-AA53, Notice of Proposed Rulemaking on Enterprise Underwriting Standards Relating to Mortgage Assets Affected by PACE Programs

The American Securitization Forum[1] ("ASF") submits this letter in response to the Notice of Proposed Rulemaking ("NPR") of the Federal Housing Finance Agency ("FHFA"), entitled "Enterprise Underwriting Standards," published June 15, 2012 in the *Federal Register*.[2] ASF writes to express our support for the proposed rulemaking contained within the NPR (the "Proposed Rule") regarding underwriting standards for Fannie Mae and Freddie Mac (the "Enterprises" or "GSEs") with respect to mortgage assets affected by the Property Assessed Clean Energy ("PACE") programs enacted in several states and municipalities.

Fundamentally, ASF is supportive of some of a basic goal of the PACE program—that is, to encourage consumers to make energy efficient improvements to their homes. But for the reasons described in this letter, ASF is strongly opposed to programs that would have PACE loans put in a superpriority lien position to first lien mortgages. This type of program would fundamentally reshape how mortgage credit is originated and sold in the secondary market, ultimately resulting in higher required down payments, higher interest rates and/or constriction of credit.

I. PACE Program History

PACE loans allow homeowners, who have properties in areas in land-financing districts, to finance "renewable energy and energy efficient improvements." These loans effectively act as home equity loans, which are usually backed by a tax lien with priority over any/all preexisting mortgage debt. Although these PACE programs are intended "to ensure that a property owner's

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

[2] See http://www.gpo.gov/fdsys/pkg/FR-2012-06-15/pdf/2012-14724.pdf.

ability to repay is enhanced throughout the life of the PACE assessment by the energy savings derived from the improvements,"[3] such cost savings are highly speculative given the lack of manageable standards surrounding these loans. Furthermore, PACE programs pose significant consequences for affordable mortgage credit and avoiding preventable foreclosures.

As such, through a statement of July 6, 2010 (the "Statement") and a directive of February 28, 2011 (the "Directive"), FHFA directed the GSEs to take certain prudential action to limit their exposure to financial risks associated with first-lien PACE programs. FHFA explicitly indicated that PACE programs "present significant safety and soundness concerns."[4] Fannie Mae and Freddie Mac and the Federal Home Loan Banks, which are also supervised by FHFA, provide over $5.9 trillion in funding for the U.S. mortgage markets.[5]

As stated in the NPR, "several parties brought legal challenges to the process by which FHFA issued the Statement and the Directive, as well as to their substance. The United States District Courts for the Northern District of Florida, the Southern District of New York, and the Eastern District of New York all dismissed lawsuits presenting such challenges. The United States District Court for the Northern District of California (the "California District Court"), however, allowed such a lawsuit to proceed and has issued a preliminary injunction ordering FHFA "to proceed with the notice and comment process" in adopting guidance concerning mortgages that are or could be affected by first-lien PACE programs."[6] Specifically, the California District Court ordered FHFA to "cause to be published in the Federal Register an Advance Notice of Proposed Rulemaking relating to the statement issued by FHFA on July 6, 2010, and the letter directive issued by FHFA on February 28, 2011, that deal with property assessed clean energy (PACE) programs."

II. ASF Supports FHFA's Current Proposed Rule

While well-meaning, many of these PACE programs effectively act as a consumer tax on first lien mortgage loans, and are detrimental to foreclosure prevention. These programs introduce an additional risk for lenders, who are uncertain/unaware if their mortgages will be subject to a subsequent PACE lien, and therefore subject to reordering of preexisting mortgage liens.[7] Because banks and institutional investors will require a greater premium to hold securities backed by first lien mortgages that could be subject to superpriority PACE liens, the states where PACE programs are prevalent will be subject to increased loan origination costs, which will be passed onto borrowers in the form of higher down payments, higher interest rates, documentation fees, and/or fewer mortgage loans. Furthermore, because PACE loans do not consider a

[3] Department of Energy, "Guidelines for Pilot Pace Financing Programs" pg. 3 (May 2010), http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf.

[4] Federal Housing Finance Agency, "FHFA Statement on Certain Energy Retrofit Loan Programs" pg. 1 (July 2010), http://www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf.

[5] *Id.*

[6] NPR at 36086.

[7] ASF's comments are intended to address only the discrete issue of PACE loan programs which create a tax lien with priority over any/all preexisting mortgage debt. This letter does not intend to address other types of special assessments that could be imposed at the state or local level.

borrower's ability to pay and instead are based on the value of the borrower's property, some homeowners who qualify for PACE loans may be misled into taking on obligations they cannot afford.

For reasons discussed in greater detail below, ASF believes that the Proposed Rule ensures that the GSEs, and ultimately the investors that purchase securities from the GSEs, are best served by the rule in its current form. We believe that it is critical that lien priority remain intact through the life of the loan, and that originators are able to clearly determine a borrower's ability to repay. Specifically, we agree in total with FHFA's findings that "although the [Department of Energy] Guidelines purport to incorporate "Property Owner Ability to Pay" into their "Underwriting Best Practices," FHFA is concerned that the suggested practices almost entirely disregard ability-to-repay as a meaningful criterion."[8] We believe further that the following criteria articulated in the rule are simple and clear:

1. The Enterprises shall immediately take such actions as are necessary to secure and/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. Such actions may include, to the extent necessary, interpreting or amending the Enterprises' Uniform Security Instruments.
2. The Enterprises shall not purchase any mortgage that is subject to a first lien PACE obligation.
3. The Enterprises shall not consent to the imposition of a first-lien PACE obligation on any mortgage.

These three criteria provide certainty to the secondary market, and will allow for the flow of mortgage credit to continue unabated.

III. Discussion of FHFA Proposed Alternatives

First Risk-Mitigation Alternative—Guarantee/Insurance

ASF would support the first risk-mitigation alternative through the use of an insurance mechanism so long as any of the three prongs of subpart (c) are satisfied. Specifically, (i) repayment of the PACE obligation is irrevocably guaranteed by a qualified insurer, with the guarantee obligation triggered by any foreclosure or other similar default resolution involving transfer of the collateral property; (ii) 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 resolution involving transfer of the collateral property; or, (iii) the PACE program itself provides, via a sufficient reserve fund maintained for the benefit of holders of mortgage interests on properties subject to senior obligation under the program, substantially the same coverage described in clause (ii) above.[9] We share the cautious view espoused by FHFA with respect to both the availability of such an insurance product in the market, and whether the insurer would

[8] NPR at 36102.

[9] NPR at 36107-36108.

be available to pay claims. We would expect that, should FHFA move forward with this alternative, FHFA would require the GSEs to build in protections to ensure that investors are protected against this type of risk.

Second and Third Risk Mitigation Alternatives—Protective Standards/Underwriting Standards

As stated previously, we believe that protecting lien priority is critical to ensuring that mortgage credit remains available to all creditworthy borrowers. We share the concerns expressed by FHFA with respect to both the second and third alternatives. We agree with FHFA's reservations about the Second Risk-Mitigation Alternative, including "whether it would reduce but not eliminate the material financial risks that first-lien PACE programs would otherwise pose to the Enterprises."[10] Simply reducing the risk of loss borne by the Enterprises, and ultimately the investors in these types of securities is not sufficient to ensure appropriate liquidity in this market. In addition, we agree further with the concerns raised by FHFA with respect to the third alternative questioning whether that proposed alternative "could practically be implemented by FHFA and the Enterprises given that certain elements of the alternative appear to be inherently vague and/or dependent upon assumptions that FHFA lacks a sound basis (and the requisite staff and resources) to provide or evaluate."[11]

IV. Further Discussion of the Negative Impacts of PACE Programs

ASF requests that FHFA promulgate a final rule based on the following three primary concerns, which were expressed by many commenters during the advance notice of proposed rulemaking ("ANPR") process.

1. *PACE Programs Hurt Consumers By Increasing the Cost of Mortgage Loans and Refinancings*

Various financing techniques are used to make consumer loans more affordable to the public, including securitization. It is estimated that securitization has funded between 30% and 75% of lending in various markets.[12] Through securitization, banks are able to turn illiquid assets, such as mortgage loans, into securities that can be sold to investors, thereby freeing up immediate funds to allow for more loan originations and cheaper credit for consumers.

ASF members, who include the most recognized names in commercial and consumer finance, are very concerned that PACE programs will have a chilling effect on mortgage financing in areas that allow for PACE loans. Because PACE loans are usually added to the associated property's tax assessment, these loans are superior to preexisting mortgage liens on the property. This reordering of lien priorities may significantly diminish the economic returns derived from the GSEs' purchasing or refinancing of these loans. Furthermore, mortgages with PACE loans

[10] NPR at 36108.

[11] NPR at 36109.

[12] Citigroup, "Does the World Need Securitization?" pg. 10-11 (Dec. 2008), www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf.

are unattractive to hold because they are underwritten in a manner that is not indicative of a borrower's ability to pay. Instead, PACE programs are based on property value, and whether the property is located in a financing district that allows for such loans.

Ultimately, mortgage purchasers such as Fannie Mae and Freddie Mac will need to be compensated for the additional uncertainty and risk they bear by purchasing mortgages with PACE liens. Mortgage lienholders will have no way of knowing in advance whether a borrower will take on a PACE lien in the future, because borrowers only need to notify mortgage holders after a PACE lien is already placed on the property.[13] As a result, lenders and mortgage originators will pass the increased costs of selling off mortgages to the GSEs onto borrowers in the form of higher interest rates or refinancing fees. Although many of these PACE programs are intended to benefit consumers and promote energy efficiency and conservation, these programs will effectively act as a tax for homeowners seeking a mortgage loan or a refinancing in jurisdictions that allow for such loans.

2. *PACE Programs Lack Adequate Consumer Safeguards*

In addition to increasing the mortgage costs for consumers, these loans lack Truth in Lending Act ("TILA") oversight and other forms of consumer protections,[14] making these programs conducive to abusive lending practices. One of the key purposes of TILA is "[to] assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."[15] Federal banking regulators have passed regulations such as the amendments to Federal Regulation Z, which requires specific disclosures for "high-cost mortgage loans." However, there are no similar federal regulations which mandate that specific disclosures be made to consumers for PACE loans. Additionally, because PACE loans act effectively as an economic stimulus for certain business sectors, self-interested parties may be incentivized to misrepresent the cost-savings of installing "energy-saving equipment." As a result, borrowers who opt to participate in PACE programs may be subjected to various forms of fraudulent behavior and abuse. Given the recent financial regulatory reforms designed to address abusive lending practices, PACE loans generally represent a step back from fostering adequate consumer protections and addressing mortgage finance reform.

3. *PACE Programs Impair the Secondary Mortgage Market by Negatively Affecting the Value of RMBS*

Fannie Mae and Freddie Mac own or guarantee nearly half of all residential mortgages in the U.S., many of which have been securitized. In the case of borrower default or foreclosure, the PACE tax lien is usually superior to existing mortgage liens. This would have an immediate negative and retroactive impact on the value of mortgage-backed securities, as investors may not have priority with respect to the cashflow being paid on these loans.

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[13]Department of Energy, *supra* note 2, at 3.

[14] *See* Federal Housing Finance Agency, *supra* note 3.

[15] § 15 U.S.C. §1601(a)

As a result of the uncertainty introduced into the secondary markets by these programs, holders of securities backed by Fannie Mae and Freddie Mac loans with PACE liens would require a higher return that would ultimately be passed onto consumers in the form of higher interest rates and refinancing fees. Additionally, while investors may want to hold PACE liens because of their superior lien status, this would occur at the expense of borrowers, many of whom may not be able to afford to pay off the PACE loans and stay in their homes. Ultimately, these programs will inadvertently cause harmful consequences for the value of mortgage-backed securities that have PACE tax liens, including securities contained in pension and mutual funds.

V. Conclusion

The adverse impact of these PACE programs on affordable mortgage credit in states and municipalities that allow PACE loans will be substantial. Ultimately, the allowance of a reordering of lien priorities as contemplated by PACE programs jeopardizes homeownership, increases the cost of mortgage loans and refinancing, and ultimately chills a part of the economy that is in desperate need of stimulus.

On behalf of our members, I thank you for your consideration of our views with respect to this NPR. For additional information or additional follow-up directly with our members, please do not hesitate to contact me at 212.412.7107 or at tdeutsch@americansecuritization.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum