FannieMae

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Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Eighth Floor
400 Seventh Street, SW
Washington, DC 20024

Re: Comments on Advance Notice of Proposed Rulemaking: Mortgage Assets Affected by PACE Programs; RIN 2590-AA53

Dear Mr. Pollard:

Fannie Mae is pleased to submit these comments in response to the Federal Housing Finance Agency's ("FHFA") Advance Notice of Proposed Rulemaking on Mortgage Assets Affected by Property Assessed Clean Energy ("PACE") Programs[1] dated January 26, 2012 (the ANPR").

PACE Programs permit local governments to provide financing to homeowners for energy-related home improvements. A hallmark of most PACE Programs is that a PACE loan can take priority over a mortgage loan that had been originated as a first lien. Even before FHFA determined that certain PACE Programs present significant safety and soundness concerns to Fannie Mae and Freddie Mac (the "Enterprises"), Fannie Mae had analyzed PACE Program risks and issued guidance to lenders that provided, among other things, it would no longer purchase mortgage loans secured by properties with outstanding first-lien PACE obligations. On February 28, 2011, FHFA directed the Enterprises to "... continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations."

Pursuant to the ANPR, FHFA requested comments on several issues. The fundamental question (Question 1) is whether conditions and restrictions relating to the Enterprises' dealing in mortgages subject to PACE loans are necessary. FHFA also asks for comments directly related to issues of lien priority (questions 2-4); market options to PACE Programs (Questions 5-8); consumer protections and disclosures (questions 9-13); underwriting standards (questions 14-16); and alternatives to FHFA's existing statements concerning PACE Programs (question 17). In response to FHFA's request for comments, Fannie Mae offers background on its support of energy efficiency efforts and its policies surrounding PACE Programs, as well as a discussion of the most significant risks

[1] 77 Fed. Reg. 3958

associated with PACE Programs.[2] While many of the questions posed by FHFA are directed to participants in the PACE lending industry, our comments below respond to the basic question of whether a restriction on the purchase of mortgage loans secured by properties encumbered by PACE loans is necessary or appropriate by discussing the impact of a priming lien feature on first-lien mortgage holders, the consumer protections and disclosures for PACE loan borrowers, and credit underwriting standards applicable to PACE.

Fannie Mae and Energy Efficiency Financing

Chartered by Congress in 1938, Fannie Mae is a government-sponsored enterprise whose mission is to support liquidity, stability and affordability in the secondary mortgage market. Since inception, the vast majority of Fannie Mae's business is to acquire first lien mortgage loans. In 2011, Fannie Mae purchased or guaranteed approximately 2,680,000 single-family first lien loans, many of which are secured by properties located in jurisdictions where PACE Programs have been authorized.

Fannie Mae supports energy efficiency in residential housing and encourages the development of viable financing and securitization opportunities that do not place undue risk on lenders, investors or borrowers. Since the 1970s, Fannie Mae has allowed consideration of energy efficient improvements in a variety of manners, including the calculation of debt-to-income ratios for mortgage loans eligible for sale to us. Currently, Fannie Mae allows borrowers to finance the cost of energy efficiency improvements, within limits, as part of the purchase or refinancing of their property.[3] In addition, Fannie Mae is participating in the U.S. Department of Housing and Urban Development's FHA PowerSaver Program by purchasing PowerSaver loans. Fannie Mae recognizes the need for programs to help homeowners fund energy efficiency improvements, but we believe such programs can be successful without altering the lien status of first mortgages.

Fannie Mae and PACE Programs

In early 2009, Fannie Mae began monitoring PACE Programs. Of immediate concern to Fannie Mae was that PACE loans generally have lien priority over mortgage liens. Because of significant risks associated with this aspect of PACE Programs, on September 18, 2009, Fannie Mae issued Lender Letter 07-2009 informing its sellers and servicers about PACE Programs and instructing servicers to advance funds when necessary to keep any known PACE loan current to protect Fannie Mae's lien priority. At the time Lender Letter 07-2009 was issued, approximately 10 states had PACE enabling legislation.

Throughout the remainder of 2009 and into 2010, Fannie Mae continued to monitor the rapid adoption of PACE Programs. By the end of 2010, more than 20 states had enacted PACE legislation, giving rise to PACE Programs in more than 200 localities in California

[2] For purposes of this comment letter, references to PACE loans shall be those that attain first lien position unless otherwise noted.

[3] Fannie Mae Selling Guide, Section B5-3.3-01

alone. Of additional note was the considerable risk PACE loans posed to consumers, including interest rates significantly higher than market for secured loans.

Upon full review of identified risks, the increasing volume of localities adopting PACE Programs, as well as extensive discussions with FHFA, energy advocates and mortgage lenders, Fannie Mae determined that PACE Programs would potentially increase the frequency and severity of its credit losses. To mitigate these risks, Fannie Mae issued Announcement SEL-2010-12, dated August 31, 2010, which informed lenders that Fannie Mae would no longer purchase loans secured by properties with outstanding PACE loans originated on or after July 6, 2010. This Announcement assured borrowers who obtained a PACE loan that Fannie Mae would waive the uniform security instrument prohibition against such loans if we purchased the mortgage loan before July 6, 2010.

Significant Risks Associated with PACE Programs

Fannie Mae believes that it is appropriate and necessary for FHFA to impose conditions and restrictions on our dealings in mortgages secured by properties subject to loans made under PACE Programs. There are significant risks associated with PACE Programs because of the potential to increase the frequency and severity of credit losses to Fannie Mae (or any other mortgage loan investor), as well as other possible adverse consequences for borrowers. The most significant risks derive from the lien priority of PACE loans, potential increases in loss severity as a result of PACE loans, and increases in credit risk because of the limited assessment of a borrower's ability to repay a PACE loan.

Lien Priority of PACE Loans

PACE loans are afforded the same statutory lien priority as real property taxes and special assessments. This means they may attain priority over any other mortgage lien against the property, including first mortgage liens that were recorded prior in time to the PACE loan. If a borrower defaults on a PACE loan, the PACE lender can effectively "step ahead" of the first mortgage holder by foreclosing on the borrower's property. The foreclosure process also eliminates, or "wipes out" all subordinate liens against the property, potentially transforming Fannie Mae's mortgage loan into an unsecured loan. As noted above, Fannie Mae instructed servicers to advance funds for known delinquent PACE loans in order to maintain lien priority, effectively making Fannie Mae a guarantor of PACE loans.

Although real property taxes pose similar risks to Fannie Mae, there are ways to manage these risks that are simply not effective in the PACE context. Real estate taxes are known and accounted for at the time of mortgage origination. As a result, a mortgage lender can factor the tax payment into its underwriting analysis of the borrower's ability to repay the loan. The underwriting essentially acts as a backstop to ensure that the borrower will be able to pay the taxes, and to protect the first lien status of Fannie Mae's loan. In addition, the mortgage lender can escrow an amount each month to pay the tax bill on the borrower's behalf, further decreasing the likelihood of a tax lien arising and attaining priority over the mortgage lien.

In contrast, PACE loans may be originated at any point during the term of a mortgage loan without the knowledge of the current servicer or investor, making escrowing for PACE loans practically impossible. Moreover, because PACE lenders do not generally consider the borrower's ability to repay the loan, the risk of default is higher than on other secured loans, which in turn increases the risk that existing mortgage loans will be subordinated and wiped out.

Increase in Loss Severity

PACE loans would increase the severity of Fannie Mae's losses in the event of foreclosure on the mortgage loan. Subsequent owners of PACE-encumbered properties are liable for continuing payments on the PACE loan. In selling real estate owned (REO), Fannie Mae will need to: (i) cure any arrearages on the PACE loan and keep it current to convey clear and marketable title to a purchaser; and (ii) in Fannie Mae's opinion, pay off the entire amount of the PACE loan to attract purchasers, given the number of properties on the market which are not encumbered by PACE loans. In at least one state, the amount of a PACE loan can be up to 40% of the value of the underlying property.[4] It is not difficult to imagine that paying off a PACE loan, or even curing arrearages, could significantly increase Fannie Mae's cost to dispose of the REO.

PACE Loans Increase Fannie Mae's Credit Risk on Mortgage Loans.

PACE loans also concern Fannie Mae because they alter the credit risk attributes of Fannie Mae-acquired mortgage loans. A PACE loan increases a borrower's debt burden with little, if any, consideration of the borrower's ability to repay the PACE loan. Features of PACE Programs vary widely, but may include double digit interest rates, property-based lending with little or no consideration of the borrower's ability to repay the loan, and the complete absence of compliance with federal and state consumer protection laws, such as the Truth in Lending Act. One Colorado program specifically noted in its consumer communications that PACE was a good option for borrowers who "[a]re not likely to qualify for a lower-interest loan through a private lender (e.g. home equity loan) due to less-than-excellent credit or lack of equity." This lack of robust underwriting standards is inconsistent with the requirements of the Mortgage Reform and Anti-Predatory Lending Act of the Dodd-Frank financial reforms and proposed implementing regulations, which require creditors to determine a borrower's ability to repay a loan secured by a lien on a borrower's dwelling without regard to the consumer's equity in the dwelling.[5]

PACE Programs' lack of uniform, prudent and customary lending practices increases the risk that the borrower will default on the PACE loan. As indicated above, a default on a PACE loan will have a negative impact on Fannie Mae's mortgage loan. Prudent lending

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[4] N.M. Stat. Ann. § 4-55C-1

[5] 15 U.S.C. §1639c

standards are employed to minimize risk to the lender as well as to the borrower. Fannie Mae requires lenders to carefully evaluate a borrower's ability and willingness to repay the loan, and determine the adequacy of the property to serve as collateral for the debt. Among the factors reviewed include the borrower's credit history, total debt obligations, employment, income and appraised value of the property.

PACE Programs, in contrast, typically rely primarily on the property for assurance of repayment rather than on the borrower's demonstrated ability to repay the loan. PACE loan applications are commonly approved without determination that the prospective borrower has a source of income to pay monthly housing expenses and other obligations. For example, the Sonoma County Energy Independence Program specifically states that qualification is not dependent on the consumer's income. In such cases, there is no assurance that the borrower has adequate resources to make timely payments on the PACE loan, increasing the likelihood that the PACE lender will have to rely on the collateral, i.e., foreclose, to obtain repayment of the debt.

Conclusion

Fannie Mae continues to support energy efficiency in residential housing. However, PACE Programs with first-lien priority features have the potential to increase losses to Fannie Mae and place undue risk on lenders, investors, and borrowers. For these reasons, Fannie Mae supports FHFA's position on PACE Programs.

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Fannie Mae very much appreciates the opportunity to provide the foregoing comments to FHFA.

Sincerely,