

PICKING UP THE PACE WITH FANNIE AND FREDDIE

BY DAN WILES, PRINCIPAL

One of the latest “hot trends” in public finance is the Property Assessed Clean Energy bonds. In California, we refer to them by their authorization as “AB 811 deals.” PACE transactions are planned as contractual assessments against property, either residential or commercial, to support the repayment of financing issued to provide energy and/or water conservation improvements. These improvements can include, but also extend far beyond, photo voltaic solar panels. Improvements as fundamental as insulation, weather-stripping, on demand water heaters and the like, can fall within the definition of eligible improvements. As of this writing, no California jurisdiction has actually issued bonds to the public based solely on AB 811 contractual assessments.

The key to these financings is the status of the contractual assessment. Similar to all real property assessments and real property taxes, the lien securing PACE financings has a priority ahead of (senior to) mortgages secured by the property. If the taxes and assessments are not paid, the lien could be foreclosed with the property is sold to satisfy any unpaid amounts. With a higher priority, the amounts due on the PACE transaction are paid first, before any amounts on the mortgage. If the proceeds of the sale are less than the amount needed to pay both the tax and assessment lien and the mortgage, the mortgage is not fully paid.

That priority provides a solid credit foundation for a PACE financing, making the bonds acceptable to investors. On the flip side, the priority of the tax and assessment lien impairs the security of the mortgage. As purchasers of the majority of residential mortgages in the United States, both the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) have a keen interest in the development of PACE financings.

AB 811 provides no specific limit on the possible size of a contractual assessment lien for energy improvements. Absent other specific requirements, the lien could completely eliminate the property owner’s equity and significantly impair the security of the mortgage. Some agencies planning PACE programs have included limitations on the size of the assessment lien relative to the value of the property and the total amount of outstanding debt. The general goal has been to limit the financing to less than the property owner’s existing equity.

On May 5, 2010, both Fannie Mae and Freddie Mac issued guidance letters to sellers and servicers of mortgages, containing substantially similar messages. The Fannie Mae letter states: “The terms of the Fannie Mae/Freddie Mac Uniform Security Instruments prohibit loans that have senior lien status to a mortgage.” The Freddie Mac letter states: “The purpose of this Industry Letter is to remind Seller/Servicers that an energy-related lien may not be senior to any Mortgage delivered to Freddie Mac.”

Both Fannie Mae and Freddie Mac emphasized their support for energy efficiency initiatives and expressed interest in working with federal and state agencies on program development. For now, the ultimate resolution of this issue as these programs move beyond the experimental stage is unclear. ♦

** The information in this newsletter is intended to be general in nature. The facts and circumstances of each agency are different. Seek specific advice before implementing any recommendation.
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