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FHA Issues Final Guidelines on PACE Assessments: Dechert

The U.S. Federal Housing Administration (FHA) issued final guidance in the form of Mortgagee Letter 2016-11 regarding the subordination of Property Assessed Clean Energy (PACE) assessments on Tuesday, July 19, 2016. As originally announced in August of 2015, the guidelines are part of a broader initiative to expand the accessibility of clean energy financing options while simultaneously preserving the value of underlying property with PACE assessments.¹ Most PACE programs permit the PACE assessment to generate a lien on the property that is pari passu with real estate taxes and other assessments on real property and comes ahead of any mortgage lien on the property; a structure for which both the FHA and the Federal Housing Finance Agency (FHFA), the conservator of Fannie Mae and Freddie Mac, have expressed concerns. To address these concerns, the FHA announced that it will begin insuring mortgages on properties with PACE assessments that meet five conditions.

FHA Guidance on PACE Assessments

Super-Priority Lien Status

The paramount condition in the FHA guidance is centered around the concern that PACE assessments could take super-priority lien status over a mortgage in the event of default or foreclosure. Under this condition, PACE assessments cannot have superior priority lien status to the mortgage, except in the event of a default. Even in the event of default, a PACE assessment can only take priority over an FHA-insured mortgage to the extent of the installment of the PACE assessment that is delinquent. The guidelines also indicate that an event of default cannot accelerate full repayment of the PACE assessment; although, the guidelines permit a notice of lien with respect to the full PACE assessment amount to be filed in the public records.²

Special Assessment Treatment

A second condition requires that PACE assessments are collected and secured in the same way as a special assessment against the property (i.e. the PACE obligation must be escrowed by the lender).³ Essentially, this condition clarifies that the FHA will insure mortgages with PACE assessments attached if such assessments are treated like a property tax under state law, but will not do so if the PACE assessment is given first priority lien status in a manner other than described under the first condition.⁴ Legally, the FHA cannot accept PACE assessments that would treat the entire PACE assessment as a priority lien over the mortgage, except in circumstances of default or delinquency similar to other property tax assessments.⁵ This condition should please mortgage lenders, however, it does raise a concern about what would happen in a scenario where the FHA-insured mortgage enters into default and the defaulted assessment amount exceeds the escrow amount. It is unclear whether the FHA would be required to pay the remaining amount owed or whether that amount would be passed along to the purchaser of the foreclosed property.

Free Transferability

A third condition requires that there are no terms or conditions of the PACE assessment that would

limit the transfer of the encumbered property to a new homeowner. This requirement includes a prohibition against a restriction that could require third-party consent to transfer the property, unless such restriction could be terminated at no cost by the homeowner.⁶

Public Record

A fourth condition requires that the PACE assessment be readily apparent in public records to all parties involved in the mortgage transaction and must: (i) state the loan amount; (ii) include the expiration date and cause of expiration; and (iii) specify that a default cannot accelerate the expiration date.⁷ It is not clear how this requirement will affect PACE programs that allow for a delay in the filing of the assessments in the public records.

Continue with the Property

A fifth and final condition requires that the PACE assessment attach to the property upon sale, including foreclosure.⁸ This requirement ensures that, in the event of a foreclosure or deed in lieu thereof, the balance of the PACE assessment will transfer to the new property holder instead of becoming immediately due and interfering with payment of the mortgage loan.

Disclosure and Appraisal Requirements

The FHA guidance further includes disclosure and appraisal requirements.

The disclosure requirement specifies that, in the event of sale of a property with a PACE assessment, the sales contract must specify whether the PACE assessment will remain attached to the property or if it will be satisfied by the seller at or before closing.⁹ If the PACE assessment will remain attached, all terms and conditions of the PACE assessment must be disclosed to the buyer and further made part of the sales contract.

Lastly, if the PACE assessment will remain with the property, any appraiser must include in its analysis the impact of the PACE-related improvements (i.e. solar panels) on the value of the property, irrespective of whether such impact is positive or negative.¹⁰

Lingering Questions and Concerns

While the FHA's guidance is certainly a step in the right direction, there are still loose ends that need to be tied up. First, it is unclear from the guidelines who will be charged with enforcing the various conditions and requirements therein. For example, who will ensure that an appraiser is considering the impact of the PACE-related improvements on the value of the property? Will someone at the FHA scrutinize the appraisal, or will the program administrators be stuck with this task?

Second, the FHA's previously-issued guidance in 2015 stated that the FHA intended to coordinate with the Consumer Financial Protection Bureau (CFPB) to address consumer disclosure requirements, yet the final guidance does not refer to any such collaboration. Additionally, though the Department of Energy's Best Practices Guide for Residential PACE Financing (Best Practices Guide) stresses the importance of property owner education and disclosures,¹¹ the utilization of the Best Practices Guide is not mandatory. The FHA explicitly states that it may be used to align state and county PACE programs with consumer protection goals; however, state and local legislatures are not required to utilize the Best Practices Guide.

Lastly, we note that under the "Fair Housing and Equal Opportunity" resources section at the end of

the Best Practices Guide, there is a link to the U.S. Department of Housing and Urban Development's website for the purpose of providing more information on "program structure, operation and evaluation to ensure equal access under the Fair Housing laws."¹²

FHFA's Position Remains Unchanged

The FHFA, the conservator of Fannie Mae and Freddie Mac (who collectively represent roughly 80% of the residential mortgage market), has a long-standing objection towards the "super-priority lien" status of PACE assessments, citing lack of knowledge on behalf of lenders as well as the lenders' inability to account for additional risk and potential decline in the value of the property.¹³ Indeed, the FHFA recently stood by its objection to PACE assessments receiving super-priority lien status, stating that it does not intend to allow Fannie Mae or Freddie Mac to purchase mortgages on properties encumbered by PACE assessments.¹⁴

Conclusion

The guidelines promulgated by the FHA are a positive development and will allow property owners with existing PACE obligations—or those who wish to obtain them—to receive FHA-insured mortgage loans. Any positive impact will be mitigated, however, by the fact that the guidelines will affect roughly only 15% of the residential mortgage market. To have a more resounding and pervasive impact, the FHFA would have to release similar guidelines, yet it remains unclear whether they will do so.

Footnotes

- 1) U.S Department of Housing and Urban Development, Guidance for Use of FHA Financing on Homes with Existing PACE Liens and Flexible Underwriting through Energy Department's Home Energy Score, (August 2015).
- 2) U.S Department of Housing and Urban Development, Mortgagee Letter 2016-11, (July 2016).
- 3) Id.
- 4) U.S. Department of Housing and Urban Development, FHA to Insure Mortgages on Certain Properties with PACE Assessments, Real Estate Rama, (July 2016).
- 5) Id.
- 6) U.S. Department of Housing and Urban Development, Mortgagee Letter 2016-11, (July 2016).
- 7) Id.
- 8) Id.
- 9) Id.
- 10) Id.
- 11) See Department of Energy, Best Practices Guidelines for Residential PACE Financing, Page 5 (July 2016).
- 12) Id. Page 14.
- 13) U.S Department of Housing and Urban Development, Statement of Alfred M. Pollard, General Counsel, FHFA, before the California Legislature, Keeping Up with Pace, (June 2016).
- 14) FHFA Won't Budge on PACE LOANS, Asset-Backed Alert, (July 29, 2016).

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