MEMORANDUM FOR THE CONTRA COSTA COUNTY BOARD OF SUPERVISORS

TO: Internal Operations Committee

FROM: Tyra Wright, Chair, Local Government Relations Committee, Contra Costa Association of REALTORS®
Carla Weston, Local Government Relations Committee, Contra Costa Association of REALTORS®
Nick Solis, Local Government Relations Committee, Contra Costa Association of REALTORS®
Heather Schiffman, Director of Government Affairs, Contra Costa Association of REALTORS®

RE: Requested Information

DATE: February 27, 2015

We appreciate the opportunity to respond to the questions that were asked during the Internal Operation Committee Meeting on November 3, 2014 with Supervisor Karen Mitchoff and Candace Andersen. As it was explained during the meeting the Contra Costa Association of REALTORS® (CCAR) appreciates the County's efforts to provide constituents with options to update their homes with energy saving products. We also respect private property rights and the ability of individuals to enter into contracts. However, as representatives of over 3,600 real estate professionals in the county, our concern is that PACE/HERO loans have significant potential problems.

As requested by the Internal Operation Committee, we would like to provide the following answers to the questions provided by Julie Enea, Senior Deputy County Administrator and liaison to the Internal Operation Committee:

> 6. What problems do mortgage lenders report regarding mortgage sales and refinancing of properties with PACE/HERO liens?
>
> Attached is a letter from the American Bankers Association in conjunction with the Consumer Mortgage Coalition, Housing Policy Council of the Financial Services Roundtable, Independent Community Bankers of America and the Mortgage Bankers Association, dated September 13, 2012. When an attempt was made to reach out to banks such as Wells Fargo, their representative was not willing to provide anything in writing as they follow the directive of FHFA and referred me back to their letters.
>
> 9. What is the position of the local real estate association boards on PACE/HERO financing?
>
> CCAR supports voluntary programs over mandatory, therefore we have not taken an official position on opposition to the programs, as they are voluntary. However, we are very concerned about these programs. The disclosures are unclear, the potential liability to our members are uncertain, and the risks to the homeowners could be substantial. When a homeowner perceives that the County is backing a program like this it appears as a stamp of approval and therefore, homeowners are not likely to seek additional information regarding the programs offered.

10. What happens when a new buyer doesn't want to assume the PACE/HERO lien?

One of two things can occur; the seller must pay the loan in full, plus interest or the buyer walks away and sale does not go through.

13. How many PACE/HERO lienholders were able to sell/finance since the settlement of the FHFA lawsuit without having to repay the entire PACE loan balance? How many instances have occurred of a buyer withdrawing from the sale or requiring the owner to remove the equipment or repay the PACE/HERO balance because the buyer refused to PACE/HERO upgrade/encumbrance?

As this program is so new, there is lack of information currently available at the state or local level. However, we would suggest that you refer to the attached backgrounder information provided by the Inland Valleys Association of REALTORS® (Riverside County), where the programs began and where most of the loans reside. Additionally, our Sacramento Lobbyists have requested data from HERO regarding transactions and have yet to receive any documentation to date.

14. Is there any evidence that PACE/HERO projects actually increase a property's appraised value or, conversely, that a PACE lien has been a hindrance to resale?

There is no way to prove that a home with a PACE/HERO or any energy modification to the homes can increase a property's value. When in process of selling a home, appraised values are determined by finding properties nearby (generally within half mile to one mile radius) that have sold recently and are of the same or similar configurations (generally no longer than 12 months ago) that would support a price.

Even though there was not a question confirming that status of the Federal Housing Finance Agency's (FHFA) position regarding these types of loan, we have included past and a recent statement dated December 22, 2014 from FHFA stating, "*FHFA has an obligation to protect Fannie Mar's and Freddie Mac's rights, and will aggressively do so by bringing actions to void foreclosures that purport or extinguish Enterprise property interests in a manner that contravenes federal law.*"

Please find attached the following items:

- American Bankers Association, Consumer Mortgage Coalition, Housing Policy Council of the Financial Services Roundtable, Independent Community Bankers of America and Mortgage Bankers Association – *September 13, 2012*
- Inland Valleys Association of REALTORS® Backgrounder
- Statement of Melvin L. Watt Director, FHFA Before the U.S. House of Representatives Committee on Financial Services (ref on page 12 of the statement)– *January 27, 2015*
- Statement of the Federal Housing Finance Agency on Certain Super Priority Liens – *December 22, 2014*
- Two letters to California Governor Brown – *May 1, 2014*

American Bankers Association
Consumer Mortgage Coalition
Housing Policy Council of the Financial Services Roundtable
Independent Community Bankers of America
Mortgage Bankers Association

September 13, 2012

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 Seventh Street, S.W., Eighth Floor
Washington, D.C. 20024
RegComments@fhfa.gov

Re: Comments: RIN 2590-AA53

Dear Mr. Pollard:

The undersigned are pleased to have the opportunity to submit comments on the Federal Housing Finance Agency's ("FHFA") proposed rule on enterprise underwriting standards relating to property assisted clean energy ("PACE") programs.

After reviewing the comments on an advance notice of proposed rulemaking, FHFA proposes a rule relating to PACE programs as they impact Fannie Mae and Freddie Mac (the "GSEs"). FHFA proposes to require the GSEs to secure their rights to accelerate loans on properties that become subject to a PACE lien without the mortgage holder's consent. In addition, FHFA proposes to prohibit the GSEs from purchasing mortgage loans on properties on which there is a PACE first lien. Finally, FHFA proposes three risk mitigation alternatives.

While we appreciate the extent to which FHFA has explored alternatives that would remove the risks of PACE loans, we cannot support them. The risk mitigation alternatives would provide varying degrees of protection for taxpayers and for consumers. However, none would address who would pay the cost of implementing them. It appears that they would impose additional duties on servicers without providing reimbursement.

It is also not clear whether the Consumer Financial Protection Bureau ("CFPB") has had the opportunity to address the predatory mortgage lending aspects of PACE loans, which we believe are unacceptable, as currently designed. We would encourage the FHFA to consider the potential predatory lending abuses that may result from PACE loans, along with the CFPB. At a minimum, we believe the ability-to-repay rule required by the Dodd-Frank Act should apply to residential PACE loans.

Even if all the consumer protections issues were resolved and even if servicers could require compensation for their PACE-related services, the fact remains that PACE liens often take priority over preexisting mortgage liens. Therefore, we cannot support the PACE loan program.

PACE Loans

PACE programs are a method of financing energy retrofit equipment installations on real property. These programs are the 2012 version of the aluminum siding door-to-door sales programs that occurred in the late 1960s to the detriment of many borrowers. Under a typical PACE program, a municipality lends funds, often raised by issuing municipal bonds, to real property owners for energy retrofit purposes. Property owners repay the PACE loans over a number of years, typically 15 or 20 years, during which they pay interest. Generally, the loans are not prepayable. The municipality collects loan payments through its tax assessments. Like unpaid property taxes, an unpaid PACE loan results in a lien on the property, and that lien usually is a super-lien, meaning it takes priority over preexisting mortgage liens.

PACE municipal bonds are attractive to investors because they are backed by the loan payments that property owners make on the PACE loans. The bonds are also attractive because they enjoy the protections of using the municipality's tax assessment mechanism. Investors are also ensured of receiving their income stream without prepayment, adding to the value of their investment. PACE investors have strong reasons to advocate for more PACE lending. It does not necessarily follow that they are suitable for consumers or that a super-lien in front of a GSE mortgage is protective of taxpayers.

Ignoring Lessons Learned

PACE loans, as currently designed, ignore the lessons learned from the current mortgage crisis:

- Consumers should not obtain mortgage loans they are unable to repay.
- Consumers should not necessarily borrow as much as someone is willing to lend.
- Lenders should bear some risk of loss upon default.
- Tapping equity in a consumer's home for the benefit of a home improvement contractor, without regard to consumer protections, can lead to abuses.
- Consumers should not be deceptively encouraged to default on their mortgage obligations.

➢ *Consumers Should Not Obtain Mortgage Loans They Are Unable to Repay*

One of the most significant lessons learned from the mortgage crisis is that consumers should not obtain mortgage debt that they are unable to repay. A new requirement that consumer mortgage lenders thoroughly document ability to repay a mortgage loan, without regard to the property value, was a central aspect of the mortgage reforms in the Dodd-Frank Act.

PACE loans finance up to the entire cost of the retrofit project, without considering whether the homeowner can repay the PACE loan in addition to the mortgage. PACE lending is based on the collateral value, regardless of the borrower's ability to repay the loan. For this reason, PACE lenders do not need to underwrite the borrower's credit profile and determine whether the borrower can pay the PACE loan and the mortgage. PACE lenders will not lend more than the property value because they rely on the property for repayment, but they bear no loss if the amount of the PACE loan and the mortgage loan exceed the property value.

This is not a problem to PACE investors because of their lien super-priority, but it is a serious risk to consumers because it increases the risk they will lose their home in a foreclosure.

We question whether the Consumer Financial Protection Bureau ("CFPB") would consider PACE loans to be exempt from all the federal consumer mortgage protections, such as those under the Truth in Lending Act ("TILA"). The simple expedient that PACE loans use an unusual manner of ensuring the investor is repaid should not be enough to entirely ignore all the mortgage lending rules. In economic effect and from the consumer's point of view, PACE loans are mortgage loans. Consumers receive cash up front to make a purchase, in exchange for an obligation to make periodic payments for a length of time, with interest that accrues over time, secured by real property.

We do not believe the GSEs should deal in, or be exposed to, mortgage loans for which the ability to repay has not been adequately documented. Rather than permitting PACE loans to be exempt from the ability-to-repay rule, applying that rule to PACE loans is particularly important because PACE loans increase the risk of default and foreclosure on the non-PACE mortgage loan.

➢ ***Consumers Should Not Necessarily Borrow as Much as Someone is Willing to Lend***

Another lesson learned from the mortgage crisis is that there is a limit on the appropriate amount of consumer mortgage debt. There can be healthy debate about where that limit is or should be, but there is no reasonable argument that mortgage credit should have no economic limit. From the mere fact that a consumer might benefit from something, such as an energy retrofit project, does not necessarily follow that a lien on the consumer's home is the best way to finance it regardless of the amount of preexisting mortgage debt on the home, but that is exactly the premise of PACE financing.

➢ ***Lenders Should Bear Some Risk of Loss Upon Default***

We also learned that lenders, brokers, and others arranging a loan should have some risk of loss in the event of default. One of the problems behind the mortgage crisis is that many players had little or no such risk. The inevitable result was widespread defaults.

Investors in PACE municipal bonds will be repaid because they have a super-lien on the property. Contractors who sell and mechanics who install the PACE retrofits get paid up front. None of these parties bears the risk that the PACE loan, or the consumer's mortgage loan, will not be repaid.

At the same time, the addition of a PACE loan on a property that has a mortgage reduces the homeowner's equity in the property immediately, possibly to negative territory. The amount of equity a homeowner has is closely correlated to both the risk of default, and the severity of loss given default. PACE lending puts the risk of default, not on the PACE lender, but on the mortgage lender who did not make the PACE loan. The inevitable result will be yet more mortgage defaults.

➢ *Tapping Equity in a Consumer's Home for the Benefit of a Home Improvement Contractor, Without Regard to Consumer Protections, Can Lead to Abuses*

One more of the lessons we have learned is that if unsuspecting consumers have equity in their homes, someone else may be willing to tap that equity for their benefit at the consumer's expense. Some home improvement contractors have taken this approach in the past. A significant concern is that PACE loans may be targeted to those for whom they are least appropriate. If a homeowner with a strong credit profile finds a cost-effective energy retrofit project, that homeowner can finance it in a number of ways, such as by a subordinate mortgage or by unsecured credit. PACE projects, however, are generally not cost effective, which is why more traditional forms of financing are unavailable.

One of the reasons Congress enacted the Home Ownership and Equity Protection Act of 1994 ("HOEPA")[1] was to prevent equity-stripping. PACE loans are just a new form of equity-stripping, a type of predatory lending that has harmed consumers in the past. The only real difference is that in PACE lending, its proponents believe they have found a way around the HOEPA and TILA rules.

➢ *Consumers Should Not Be Deceptively Encouraged to Default on Their Mortgage Obligations*

Finally, we have learned that deceptively encouraging mortgage default is harmful. Fannie Mae and Freddie Mac mortgages use uniform security instruments nationwide that state that the borrower defaults on the mortgage if a lien with priority over the mortgage lien is created. The borrower is required to discharge that prior lean promptly. PACE loans often do not permit prepayment because PACE investors do not want to have their investments prepaid, that is, cease to exist. A PACE loan, then is a default on the mortgage loan that predated the PACE lien, and the borrower is not permitted thereafter to discharge the PACE lien to comply with the mortgage.

PACE programs do not make this clear to the homeowner. FHFA points to one program in which potential PACE borrowers are told that the mortgage "may" prohibit the PACE lien, and to another program in which homeowners are told that "FHFA's position" is that the mortgage prohibits the PACE lien. The GSEs' uniform security instruments are unequivocal that PACE liens that take priority over the mortgage lien are not permitted:

Borrower shall promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender, but only so long as Borrower is performing such agreement; (b) contests the lien in good faith by, or defends against enforcement of the lien in, legal

---

[1] Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, §§ 151–158, 108 Stat. 2160, 2190-2198 (1994) (codified as amended in scattered sections of the Truth in Lending Act, 15 U.S.C. §§ 1601–1667f).

proceedings which in Lender's opinion operate to prevent the enforcement of the lien while those proceedings are pending, but only until such proceedings are concluded; or (c) secures from the holder of the lien an agreement satisfactory to Lender subordinating the lien to this Security Instrument. If Lender determines that any part of the Property is subject to a lien which can attain priority over this Security Instrument, Lender may give Borrower a notice identifying the lien. Within 10 days of the date on which that notice is given, Borrower shall satisfy the lien or take one or more of the actions set forth above in this Section 4.

There is no question that a new, senior PACE lien is not permitted to remain on a property on which there is a Fannie Mae or Freddie Mac mortgage. PACE liens are a default on the mortgage.

Encouraging consumers to read their mortgage instrument is not a sound consumer protection because many will not understand it even if they do read it. Implying to consumers that "FHFA's position" is just an opinion with which consumers can reasonably disagree is misleading, at best. We cannot support government-backed programs that deceptively encourage homeowners to unknowingly default on their mortgage loans, especially in a manner that prohibits them from curing the default.

PACE Loans Misalign Incentives

The reason investors in PACE income streams advocate for them is that the tax assessment payment mechanism assures the investors that they will be repaid regardless of whether the projects are cost-effective. Their incentive is to encourage homeowners to take out the largest PACE loan possible so the PACE investor has the largest future, guaranteed, income stream. PACE investors are not affected if the property value does not increase, or if the retrofit is not cost-effective or is deficient. Likewise, they are not affected if the homeowner takes out an unaffordable PACE loan and loses the home in a mortgage foreclosure.

Under a PACE program, vendors and contractors who earn profits by selling and installing energy retrofits have an incentive to sell these retrofits. Once they make the sale, they are paid and no longer involved. They have an incentive to sell the product with the highest profit margin and get paid immediately regardless of the risks that the product may not work or actually achieve the energy savings that the vendor may advertise.

➢ ***PACE Loans are Loans, not Taxes***

Boulder County, Colorado argued that PACE liens are sound policy because they "are not significantly distinguishable from special assessment districts in other contexts, including special assessment districts designed to fund septic systems, sewer systems, sidewalks, lighting, parks, open space acquisition business improvements, seismic improvements, fire safety improvements, and even sports arenas."[2] Others made similar arguments. We do not doubt that there are beneficial ways states and municipalities can spend money. Nor do we doubt that some energy efficiency measures might be beneficial.

[2] 77 Fed. Reg. 36086, 36097 (June 15, 2012).

Unlike more traditional special property assessments, however, PACE loans affect individual property owners, one at a time. This is a significant difference because it misaligns the incentives of those involved in the transaction. Property owners elect whether to participate. This fact allows unscrupulous contractors to take advantage of unsuspecting homeowners. This misalignment of incentives is a significant concern in PACE programs, at least as they exist today.

PACE advocates' self-claimed exemption from mortgage lending rules can permit abusive practices to recur. PACE loans are more like mortgage loans than taxes, so the "exemption" from mortgage lending rules is a concern. We suggest that FHFA consult with the CFPB on the applicability of consumer mortgage rules.

Another problem with equating PACE loans with more traditional uses of special assessments is that it requires ignoring the context in which PACE loans are made. They are made based on the *assumption* that the energy project will: 1) be cost-effective; 2) result in less energy use; and 3) increase the property value. In fact, none of these is established.

➢ ***The Cost of Energy May Decrease***

The town of Babylon, New York argues that PACE programs "will help homeowners stay in their houses by reducing their utility bills while providing a hedge against rising energy costs in the future."[3] Similarly, the Environmental Defense Fund argued that "PACE will simultaneously mitigate other, more significant risks" such as energy price increases, "to yield a net decline in the chance of mortgage default."[4]

These arguments rest on the unsupported assumption that energy costs will increase in the future. Given the recent advances in modern hydraulic fracturing technology and the discovery of large domestic natural gas reserves, the opposite is certainly a realistic possibility, and would defeat the purpose of PACE programs.

This also assumes that energy costs are related to mortgage default rates, a dubious and unsupported prospect. Mortgage default rates are closely correlated with debt-to-income ratios and loan-to-value ratios. Electric bills or gas bills are minor in comparison to income and mortgage payments in most cases, and are generally irrelevant to mortgage default rates.

➢ ***Energy Retrofits Are Not Necessarily Cost Effective***

Babylon, New York argues that PACE programs "enhance the value of participating homes and, in fact, reinforce, rather than 'impair', the first mortgages."[5] Several others make similar arguments. If PACE retrofits increased property values, the property taxes would also increase proportionately. This would make a mortgage default more likely because the extra tax payments would drain cash away that would otherwise be available to make loan payments.

---

[3] 77 Fed. Reg. 36086, 36089 (June 15, 2012).
[4] 77 Fed. Reg. 36086, 36090 (June 15, 2012).
[5] 77 Fed. Reg. 36086, 36089 (June 15, 2012).

Any increase in property value would only benefit a homeowner if the increase were equal to or greater than the cost of the energy retrofit, including the cost of financing the retrofit, and the cost of the increased property taxes from any increase in property value. There is simply no evidence that this is always true.

Home values are influenced by many factors unrelated to the cost of heating and cooling a home. Home values are impacted by supply and demand, including local foreclosure rates, the location of the property, the quality of the schools, access to transportation and employment, the condition of the home, and more. When appraisers determine home values, they look at these and many other factors, but not, except in very unusual cases, at the cost of electricity or water.

PACENow, a staunch supporter of PACE financing, argues that PACE financing solves the two major impediments to energy retrofit projects – high upfront costs and fear that the costs would not be recovered upon a property sale. In other words, PACENow's argument in support of PACE financing is that the retrofit projects are *not* cost effective. *If they were cost-effective, there would be no need for PACE financing.* The energy savings from a cost-effective project would pay for the cost of the retrofit, the cost of traditional financing, and the increased property taxes due to any increased property value.

Also, if the energy retrofits were cost effective, it would be commonplace for homeowners to make the retrofits just before they sell a home because they could recover the cost, and the "resulting" increase in property value, as soon as the sale closes. Fannie Mae and Freddie Mac, who sell foreclosed properties every day, would routinely make energy retrofits on each REO property before putting it on the market. The GSEs would not need PACE financing because they can self-finance more cheaply. Moreover, they have such a large number of properties that they would use their economies of scale to purchase many retrofit products in bulk and install them at a lower cost than individual homeowners pay. Yet, the GSEs have not pursued energy retrofits because, as they well know, it would cost more than it would save.

The fact that pre-sale retrofits are not a widespread occurrence further reinforces what PACENow claims – the upfront cost is high, and the homeowner does not recover the cost upon selling the home.

The fact that energy retrofits are not cost effective for the homeowner reinforces the fact that they are not cost effective for mortgage investors.

➢ ***The Default Rate on PACE Loans is Irrelevant***

Several commenters argue that PACE loans constitute sound policy because they have a very low default rate. They are a super-lien, so it is expected that they have a low default rate. That is precisely why they are a problem for mortgage investors – the existence of the PACE loan draws away cash that would otherwise be available to make mortgage payments.

FHFA Proposes Alternatives

FHFA proposes a rule with three risk mitigation alternative. While we appreciate the attention FHFA put into its thorough and deliberate consideration of available options, we cannot support any of the alternatives at this time.

The proposed rule would provide:

> (a) 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.
> (b) The Enterprises shall not purchase any mortgage that is subject to a first lien PACE obligation.
> (c) The Enterprises shall not consent to the imposition of a first-lien PACE obligation on any mortgage.[6]

We agree with FHFA that the proposed rule is reasonable to limit, in the interest of safety and soundness, the financial risks that first-lien PACE programs would otherwise cause the GSEs to bear.[7] We add that it is also reasonable in the interests of consumer protection.

FHFA also proposes three risk mitigation alternatives, to which we now turn.

➢ ***Guarantee or Insurance***

FHFA is considering a risk mitigation alternative under which the GSEs would not consent to PACE obligations unless the obligation would be recorded in land records, and one of the following would be required:

- Repayment of the PACE obligation is irrevocably guaranteed by an insurer the GSEs determine is qualified;
- A qualified insurer insures the GSEs against all losses on the PACE obligation; or
- The PACE program provides a reserve fund, sufficient on an actuarially sound basis, for the benefit of holders of mortgage interests on affected properties.

Recording the obligation in land records is sensible. It is included in each of the three loss mitigation alternatives. However, as with many other aspects of the proposed risk mitigation alternatives, it is not clear who would pay for performing the service or for the recording taxes. We discuss the issue of who would pay for the risk mitigation alternatives more comprehensively below.

Any insurer can fail, no matter how qualified at the outset. Given that some PACE loans are for long terms, this is a significant concern. PACE programs to date do not establish reserve funds to protect mortgage holders, possibly because it would undermine the economics of PACE

[6] 77 Fed. Reg. 36086, 36107 (June 15, 2012).
[7] 77 Fed. Reg. 36086, 36107 (June 15, 2012).

investments. While that option has potential in the future, it would need to be developed. Any reserve fund would need to be protected against losses and fraud, which would be a significant undertaking.

Again, it is not clear who would pay for the servicer's confirmation that any insurance or reserve were adequate and in place.

➢ ***Protective Standards***

A second proposed loss mitigation option is protection through underwriting standards.

- The PACE obligation would be limited to the lesser of $25,000 or ten percent of the property value;
- The combined loan-to-value ratio would be limited to 65 percent;
- The borrower's documented back-end debt-to-income ratio would be no more than 35 percent;
- The borrower's FICO score would be no lower than 720; and
- The GSEs would treat a home purchaser's prepayment of a preexisting PACE obligation as part of the purchase price in determining loan amounts and in underwriting.

While these underwriting criteria are sensible, it is not clear who would verify them. If the PACE obligation were originated at the same time as a mortgage loan, the PACE requirements could be verified by the mortgage originator. However, that would be a rare occurrence because the purchase of the energy retrofit could simply be combined into the mortgage loan.

In the more likely scenario, a PACE obligation would be sought after the mortgage loan is in place. In this event, the servicer would need to underwrite the PACE obligation. If the servicer did not do so and it were later to be discovered that requirements were not met, the GSE would presumably require the servicer to buy back the mortgage loan. A third party, such as the PACE lender, would have a potential conflict of interest with the GSE and the servicer.

This option does not address the question whether the PACE retrofit is cost-effective. It simply makes it more likely that borrower will be able to afford a possible waste of money.

➢ ***H.R. 2599 Underwriting Standards***

The third option would use underwriting standards set forth in H.R. 2599, the PACE Assessment Protection Act of 2012. This bill would require PACE programs, for residential property, to require a number of protections, including:

- Property taxes on the property must have been current for three years or the property owner's period of ownership, whichever is shorter;
- There must be no involuntary liens on the property in excess of $1,000;
- There must be no default notices and not more than one property-based debt delinquency in the past three years or the property owner's period of ownership, whichever is shorter;
- The property owner must not have filed for or declared bankruptcy in the previous seven years;
- The property owner must be current on all mortgage debt on the property;

- The property title must not be subject to power of attorney, easements, or subordination agreements restricting the owner's authority to subject the property to a PACE lien;
- The property must meet any geographic eligibility requirements established by the PACE program;
- The energy retrofit must undergo an audit or feasibility study that:
  - Is commissioned by the local government, the PACE program, or the property-owner, and must not be more than 90 days old;
  - Was performed by building analyst certified by a specified organization;
  - Includes:
    - Identification of recommended energy conservation, efficiency, and/or clean energy improvements;
    - Identification of the proposed PACE-funded project as one of those recommended improvements;
    - An estimate of the potential cost savings, useful life, benefit-cost ratio, and simple payback or return on investment for each recommended improvement; and,
    - An estimate of the estimated overall difference in annual energy costs with and without the recommended improvements;
- The PACE retrofit must be determined by the local government as one expected to be affixed to the property for the entire useful life of the improvement based on the expected useful lives of energy conservation, efficiency, and clean energy measures approved by the Department of Energy ("DOE");
- The PACE retrofit will be installed by a contractor determined by the local government to be qualified;
- Disbursal of PACE funds is not be permitted unless the property owner submits to the PACE program a written request for disbursement, a certificate of completion, and adequate documentation of all costs to be financed and copies of any required permits;
- The total energy and water cost savings during the useful life of the improvements, as determined by the audit or feasibility study, are expected to exceed the total cost of the PACE assessment;
- The total PACE assessments shall not exceed 10 percent of the appraised value of the property;
- The property owner must have equity of not less than 15 percent of the appraised property value, without consideration of the PACE assessment or PACE retrofit;
- The maximum term of the PACE assessment is the shorter of 20 years or the weighted average expected useful life of the PACE retrofit, consistent with expected useful lives of energy and efficiency measures approved by the DOE.

This would be a reasonable set of criteria to ensure that PACE projects are cost-effective. However, the servicer would not approve any PACE proposal without ensuring all requirements are met in order to avoid a GSE buyback requirement. The servicer could not merely assume that the program requirements are met, even if the PACE program says they are.

Servicers do not have the expertise to verify some of the requirements. Some require understanding energy equipment. For example, the servicer would need to verify that a particular energy retrofit is expected to be affixed to the property for the entire useful life of the improvement based on the expected useful lives of energy conservation, efficiency, and clean energy measures approved by the DOE. Presumably, this would require the servicer to determine that type of equipment and whether it consistent with DOE expectations. Mortgage servicers do not have energy equipment expertise. They would need to either hire staff dedicated to PACE applications, or would need to retain a third party vendor who has the requisite expertise.

Either way, it would be costly for the servicer, but there is no apparent source of reimbursement to the servicer. Unlike the second loss mitigation alternative, this one could not be verified by the originating lender as part of underwriting a mortgage loan because it goes much farther than mortgage underwriting. Without a source of reimbursement for their costs, lenders and servicers will not be able to approve PACE proposals.

➢ ***Remaining Concerns With PACE Loans***

Consumers do not need PACE loans for cost-effective energy retrofits that they are able to afford. Without some protection, PACE loans could become a new form of inappropriate predatory lending. The CFPB has not opined on the applicability of the federal consumer mortgage laws to PACE loans, but that would be advisable.

Super-liens are a risk to any mortgage servicer or investor. No amount of ensuring an energy retrofit is cost-effective, or that the LTV is a certain level, and no amount of consumer protections, will alter this basic fact of mortgage lending. We do not believe FHFA should permit the GSEs to be exposed to the financial risks of super-liens without some sound data on which to estimate the GSEs' future resulting costs.

The responsibility for determining whether any potential PACE loan meets the several criteria would fall largely on the servicer. If FHFA does adopt one of the alternatives, servicers will need either a right to refuse to consider approving any PACE loan, or to be compensated by the PACE borrower for the extra cost of determining whether the PACE loan is acceptable, and of monitoring its future performance. Servicers will need a way of receiving compensation even if, after reviewing a potential PACE loan, the servicer determines not to approve the loan. This cost would need to be included in the calculation of whether the PACE retrofit is cost-effective.

Servicers should have the ability to require payment in full before undertaking their determination process. Servicers need the ability to refuse to consider a PACE project if considering it could put the servicer in jeopardy of noncompliance with any applicable law, such any requirements the CFPB may apply.

Conclusion

We appreciate FHFA's efforts to resolve the several issues surrounding PACE financing, including the risk mitigation alternatives. We remain concerned about the potential for predatory lending under PACE programs, and we encourage FHFA to work with the CFPB on resolving these concerns.

If FHFA adopts one or more of the risk mitigation alternatives, we request that participation not be mandatory for lenders or servicers who are not adequately compensated for the additional burdens the alternatives would place on them. Lenders and servicers should not be required to participate if doing so would risk noncompliance with any consumer protections the CFPB may apply. The best home improvement programs focused on increasing energy efficiency would be those that do not create super-liens or expose the GSEs, investors, and servicers to additional risk, which is today not quantified, and which actually deliver verifiable savings to the consumer.

Sincerely,

American Bankers Association
Consumer Mortgage Coalition
Housing Policy Council of the Financial Services Roundtable
Independent Community Bankers of America
Mortgage Bankers Association

ivar | INLAND VALLEYS ASSOCIATION OF REALTORS®

PACE/HERO Program Backgrounder

Summary: Property Assessed Clean Energy (PACE) is the generic legislative umbrella term for a series of financing programs created under several pieces of legislation in the 2000s and refined in more recent years. The basic idea is to create new options to finance energy efficiency at the household level by leveraging local governments' ability to access bond markets and, more importantly, to collect payments through tax bills. However, unlike traditional financing for local government agencies, this borrowing activity becomes a direct contract between the property and the bond market. In other words, local government agencies will not, theoretically, be on the hook for the loans. Furthermore, it's important to note that the loan is to the property, not the property's owner. This was designed to mimic the function of parcel taxes, which move easily from owner to owner without impacting a borrower's overall debt or loan-to-value (LTV) calculations.

Six companies, all built as partnerships with local governments, are active "lenders" in PACE. Six are specific to a City or small/midsize County. Two, San Diego-based HERO and Oakland-based CaliforniaFIRST, are designed to eventually operate statewide. Other, smaller programs that live on a similar chassis were authorized under separate legislation. However, the subtle differences are significant and typically mean that they have done comparably little business in the market.

HERO is, by far, the dominant player in the market. In less than three full years of active marketing and lending – most of it in portions of Riverside and San Bernardino County – the company has grown from startup to well above half a billion dollars in total activity covering more than 25,000 loans.

2014: The Problems Take Root

REALTORS in Riverside County began reporting their concerns with HERO in summer of 2014. By fall, the sporadic complaints became weekly calls to local REALTOR associations and, by winter, the contacts became daily and more serious. In numerous instances, HERO loans and associated policies are directly responsible for real estate transactions falling out of escrow. In several instances, these problems have escalated to threats of legal action. IVAR began collecting information on the program in late August and opened dialogue with HERO program executives in late fall, following an earlier meeting with a government agency responsible for midwifing HERO into Riverside County.

The specific concerns about the program are detailed below. Please note that this is a working document that will be updated regularly as information changes. This version is as of February 2, 2015.

- **Transferability**: HERO claims that the loans can be transferred to another buyer. Technically, this is true – unless the buyer needs financing. Neither FHFA nor FHA will accept PACE (HERO) balances on any loan they are asked to insure or finance. Those two entities cover about 90 percent of all financed transactions at this time. So, for all intents and purposes, HERO balances have to be paid off when selling or refinancing a home. All three agencies have issued notices and reinforced those notices on several occasions, most recently in December. For example, from Fannie Mae: "This Notice is provided as a reminder of the Fannie Mae policy prohibiting first-lien PACE loans ... As set forth ... Fannie Mae will not purchase mortgage loans secured by properties with an outstanding PACE or PACE-like loan unless the terms of the PACE program do not provide lien priority over first mortgage liens," *Fannie Mae Selling Notice, August 20, 2014.*

- **Breach of borrowing contract with existing mortgage**: One HERO disclaimer recommends that the borrower "review mortgage agreement(s) or other security instrument(s) which affect the property or to which you as the property owner are a party. Entering into a program assessment contract without the consent of your existing lender(s) could constitute an event of default under such agreements or security instruments." The reality is that for virtually anyone with a mortgage, entering into this agreement is a technical breach of their agreement and does place them in jeopardy. That said, while banks and servicers are aware that borrowers are violating their contracts, they have not (to our knowledge) taken any action to enforce remedies against borrowers.

- **Interest**: HERO loan rates carry an effective APR of 9% to 11% despite the fact that they are fully secured loans. The higher rate applies to 20-year terms. The nominal rate is about 9%, but fees and other costs push it to an effective rate of 11%.

- **Prepayment Penalties**: HERO loans carry significant prepayment penalties and minimum interest requirements. A loan of $20,000 paid off in the first year will carry minimum interest and prepayment penalties of several thousand dollars. The borrowing contracts note prepayment penalties of 5% in year one, 4% in year two and 3% in years three through five. The penalty drops to zero in year six. Update: HERO notes that it has dropped prepayment penalties on all loans, including those offered prior to 2015. The company has not – and does not plan – to send notice of the change to its borrowers. However, they state that when borrowers request a payoff statement, the penalty will not be included in the total. According to HERO, the change does not reflect any change in the contracts with the borrowers or with bondholders. It simply reflects HERO's change of heart on the issue and willingness to absorb prepayment penalties internally. This raises a concern that HERO may just as easily change its mind again to reinstate prepayment penalties at some future date.

- **Project costs out of line with market**: In dozens of cases brought forward voluntarily, REALTORS report that the cost of improvements appeared to be seriously out of step with the same type of work completed outside of the PACE/HERO Program. While any individual project may be complicated by the particular structure, Realtors involved with the homes after the fact have repeatedly reported that the costs did not appear to be supported. HERO reports that it is taking action to attempt to identify such issues. However, details and enforcement procedures appear to be lacking for now. As of late January, 2015, with about 25,000 projects complete, HERO confirmed that it has never taken legal action against a contractor.

- **Lien Disclosure**: If an owner plans to use HERO to enhance the value of their home for resale (for off, this is a flawed idea in the first place since the cost of the upgrades will be greater than the increase in resale value), they need to be sure to disclose the debt to the buyer. Because of the timing of tax bills and assessments, the debt may not appear on the tax bill at the time of sale and according to some reports, it may not show up on the title report. Update: Several of these reports later showed that the loan was indeed placed in the prelim. However, due to its placement, it was missed by everyone involved in the transaction, including agents, brokers, lenders – not to mention the buyers. While this may indicate that HERO was, technically, properly disclosing, the fact that it has been missed by veteran professionals from real estate and lending remains troubling.

- **Impound accounts**: If the homeowner has an impound account to cover property taxes, the monthly payment amount needs to be disclosed to the servicer as soon as it is applied to the bi-annual tax bill. Otherwise, the borrower may have a shortage in the first year, leading the servicer to assess the borrower for both the missed year of payments and the actual payments that have now been apportioned as a monthly additional impound assessment. In practical terms, a $200 per month payment becomes a $400 a month payment – at least for one year – if the borrower fails to notify the servicer of the tax assessment.

- **Disclosure to borrowers**: While the material concerns listed above are of tremendous concern, Realtors have taken particular issue with the belief that many of these seem to be negligently withheld from borrowers as they complete the HERO Program borrowing process. Many agents report that sellers not only did not understand the issues above, but often contested the explanation from the brokers listing their home. In contesting issues such as problems with transferability, they recounted conversations with those involved with explaining and selling the financing option to them.

- **Riverside County as the California petri dish experiment**: While the program is active in about 220 communities and about half of California counties, the vast majority of complaints in the field have come from one place: Riverside County. Specifically, western Riverside County. Most, including HERO, believe that this is due simply to the fact that HERO has been active in Riverside County since 2011 and in most other regions since 2013 or later. HERO loans have a built-in incubation period of at least five months and up to 17 months during which they exert no costs to borrowers. Further, many of the issues, including transferability problems and the resulting prepayment costs, come to light only during a transaction. In other words, Riverside County is perhaps the only region with enough history to see the problems ripen.

Testimony

Statement of Melvin L. Watt Director, FHFA Before the U.S. House of Representatives Committee on Financial Services

"Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency"

1/27/2015

Chairman Hensarling, Ranking Member Waters and members of the Committee, thank you for inviting me to testify today about our work at the Federal Housing Finance Agency (FHFA) and for providing my first opportunity to return to this Committee since I left Congress.

FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA) and is responsible for the effective supervision, regulation, and housing mission oversight of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System, which includes 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance. FHFA's mission is to ensure that these regulated entities operate in a safe and sound manner and that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA has also served as conservator of Fannie Mae and Freddie Mac (together, the Enterprises).

I am pleased to provide an overview of FHFA's statutory responsibilities and an update on the Enterprises' financial condition, FHFA's activities as regulator and conservator of the Enterprises, the FHLBanks' financial condition, and FHFA's regulatory activities as regulator of the FHLBanks.

FHFA's Statutory Responsibilities

I. FHFA's Regulatory Oversight of the Federal Home Loan Banks, Fannie Mae and Freddie Mac

The Federal Housing Enterprises Financial Safety and Soundness Act (the Safety and Soundness Act), as amended by HERA, requires FHFA to fulfill the following responsibilities in our oversight of the Federal Home Loan Bank System (FHLBank System) and the Enterprises:

(A) to oversee the prudential operations of each regulated entity; and

(B) to ensure that--

(i) each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls;

(ii) the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities);

(iii) each regulated entity complies with this chapter and the rules, regulations, guidelines, and orders issued under this chapter and the authorizing statutes;

(iv) each regulated entity carries out its statutory mission only through activities that are authorized under and consistent with this chapter and the authorizing statutes; and

(v) the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.

12 U.S.C. § 4513(a)(1).

II. FHFA's Role as Conservator of Fannie Mae and Freddie Mac

Congress granted the Director of FHFA the discretionary authority in HERA to appoint FHFA as conservator or receiver of Fannie Mae, Freddie Mac, or any of the Federal Home Loan Banks, upon determining that specified criteria had been met. On September 6, 2008, FHFA exercised this authority to place Fannie Mae and Freddie Mac into conservatorships. Subsequently, Fannie Mae and Freddie Mac together received $187.5 billion in taxpayer support under the Senior Preferred Stock Purchase Agreements (PSPAs) executed with the U.S. Department of the Treasury. FHFA continues to oversee these conservatorships.

As conservator of the Enterprises, FHFA is mandated to:

(D) ...take such action as may be--

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

12 U.S.C. § 4617(b)(2)(D).

As conservator, FHFA must also fulfill the responsibilities enumerated above in 12 U.S.C. § 4513(a)(1). Additionally, FHFA has a statutory responsibility under the Emergency Economic Stabilization Act of 2008 (EESA) to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of...available programs to minimize foreclosures." 12 U.S.C. § 5220(b)(1).

My goal, as Director of FHFA since January 6, 2014, has been to lead FHFA in meeting the mandates assigned to it by statute until such time as Congress revises those mandates.

FHFA's Actions as Regulator and Conservator of Fannie Mae and Freddie Mac

As regulator and conservator of Fannie Mae and Freddie Mac, FHFA has taken consistent actions in the past year to ensure their safety and soundness, to ensure that they provide liquidity to the housing finance market, to preserve and conserve their assets, and to ensure that they meet their obligations to homeowners under EESA.

I. Financial Performance and Condition of Fannie Mae and Freddie Mac

Since the Enterprises were placed in conservatorship in 2008, their operations have stabilized and their financial performance has improved significantly. Fannie Mae has not made a draw under the PSPA since the fourth quarter of 2011, and Freddie Mac has not made a draw since the first quarter of 2012. Some of the improvement in the Enterprises' performance relates to one-time or transitory items, such as the reversal of each Enterprise's deferred tax asset valuation allowance, legal settlements, and the release of loan loss reserves as a result of rising house prices. Part of the improvement is also attributable to other factors, including responsible business practices, strengthened underwriting practices, rising house prices, and increased guarantee fees.

While steps taken in the conservatorships have helped stabilize the Enterprises' financial condition and the mortgage market, significant challenges remain. Serious delinquencies have declined but remain historically high compared to pre-crisis levels, and counterparty exposure remains a concern. While risks from the Enterprises' mortgage-related investment portfolios are declining as the size of their portfolios shrinks, revenues from these portfolios are also shrinking. Both Enterprises continue to work to maintain and improve the effectiveness and efficiency of their operational and information technology infrastructures. Additionally, under the terms of the PSPAs, the Enterprises do not have the ability to build capital internally while they remain in conservatorship. Attracting and retaining the best qualified workforce in this period in which the future of the Enterprises is uncertain also continues to be a challenge.

Other significant financial and performance highlights about the Enterprises include the following:

Fannie Mae

- For the first nine months of 2014, Fannie Mae reported earnings of $12.9 billion compared to net income of $77.5 billion for the first nine months of 2013, which reflected a number of one-time or transitory items. Calculations have not yet been completed for 2014 and, therefore, comparisons are being made here on the basis of three quarters.
- The cumulative amount of draws that Fannie Mae has received from the Treasury to date under its PSPA is $116.1 billion. Through September 30, 2014, Fannie Mae has paid $130.5 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPA, dividends do not offset prior Treasury draws.
- The credit quality of new single-family acquisitions was strong through the third quarter of 2014, with a weighted average FICO score of 743 and a weighted average loan-to-value (LTV) ratio of 77 percent.
- The serious delinquency rate was 1.96 percent for Fannie Mae's total single-family book of business as of September 30, 2014. The serious delinquency rate for loans acquired between 2005 and 2008 was 8.27 percent compared to 0.34 percent for loans acquired since 2009 as of September 30, 2014. The serious delinquency rate for loans acquired prior to 2005 was 3.27 percent.
- Fannie Mae continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Fannie Mae's retained portfolio balance was $438.1 billion, which represents a decline of $52.6 billion since the beginning of the year, when the balance was $490.7 billion.

Freddie Mac

- For the first nine months of 2014, Freddie Mac reported earnings of $7.5 billion, compared to net income of $40.1 billion for the first nine months of 2013, which reflected a number of one-time or transitory items.
- The cumulative amount of draws that Freddie Mac has received from the Treasury to date under its PSPA is $71.3 billion. Through September 30, 2014, Freddie Mac has paid $88.2 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPA, dividends do not offset prior Treasury draws.
- The credit quality of new single-family acquisitions remained high through the third quarter of 2014, with a weighted average FICO score of 744 and a weighted average LTV ratio of 77 percent.
- The serious delinquency rate was 1.96 percent for Freddie Mac's single-family book of business as of September 30, 2014. The serious delinquency rate for loans originated between 2005 and 2008 was 7.66 percent compared to 0.23 percent for loans originated since 2009 as of September 30, 2014. The serious delinquency rate for loans originated prior to 2005 was 3.12 percent.
- Freddie Mac continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Freddie Mac's retained portfolio balance was $413.6 billion, which represents a decline of $47.4 billion since the beginning of the year, when the balance was $461.0 billion.

II. FHFA's Supervisory Activities Related to the Enterprises

FHFA's supervision function evaluates the safety and soundness of the Enterprises' operations. Safety and soundness is a top priority in meeting FHFA's statutory obligations, in execution of Enterprise strategic initiatives and in all business and control functions. FHFA takes a risk-based approach to supervision, which prioritizes examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or its compliance with applicable laws and regulations. FHFA conducts on-site examinations at the regulated entities, ongoing risk analysis, and off-site review and surveillance. FHFA communicates supervisory standards to the regulated entities, establishes expectations for strong risk management, identifies risks, and requires remediation of identified deficiencies.

In 2014, FHFA issued supervisory guidance to the Enterprises on topics related to operational risk management, counterparty risk management, mortgage servicing transfers, cyber risk management, and liquidity risk management. This guidance articulates FHFA's supervisory expectations related to those matters and informs examination activities. Examples of important guidance issued during 2014 include the following:

Advisory Bulletin 2014-05, *Cyber Risk Management Guidance*, describes the characteristics of a cyber risk management program that FHFA believes will enable the regulated entities to successfully perform their responsibilities and protect their environments. FHFA's key expectations include Enterprise assessment of system vulnerabilities, effective monitoring of cyber risks, and oversight of third parties with access to Enterprise data.

Advisory Bulletin 2014-06, *Mortgage Servicing Transfers*, articulated FHFA's supervisory expectations for the Enterprises with regard to servicing transfers of mortgage loans that they hold or guarantee. Pursuant to contracts with their counterparties, the Enterprises must approve the transfer of servicing operations or servicing rights. FHFA has focused on Enterprise approval processes for these transactions due in large part to the significant recent transfers of mortgage servicing operations from federally-regulated banks to non-bank entities that are generally subject to less regulation and are more concentrated in their operations.

Advisory Bulletin 2014-07, *Oversight of Single Family Seller/Servicer Relationships*, articulated FHFA's requirement that the Enterprises assess financial, operational, and compliance risks associated with their counterparties and develop a risk management framework that can be applied throughout the Enterprise's contractual relationship with seller/servicers.

Standards set by FHFA are also reflected in guidance to our examiners, which is provided in FHFA's Examination Manual. The manual includes twenty-six modules that cover various Enterprise operations and provide background on a range of operational, credit, and market risks. The manual is a valuable tool for implementing FHFA's risk-based approach to supervision of the Enterprises and is available on FHFA's website.

FHFA maintains a team of examiners on-site at each Enterprise, and the examiners receive support from off-site analysts and subject matter experts. Examination teams perform targeted examinations of specific Enterprise operations and conduct ongoing monitoring of risk control functions and business lines. The examination work is performed in accordance with plans prepared annually for each Enterprise, taking into account factors such as analysis of existing risks, changes in business operations and strategic initiatives, and mortgage market developments. Where FHFA's Enterprise supervision team identifies deficiencies, examiners communicate expectations for remedial action. Examiner risk assessments are updated during the year to ensure that emerging risks and Enterprise business changes receive appropriate examination coverage.

Findings from targeted examinations and ongoing monitoring conducted through the course of the year are relied upon by examiners in assigning ratings to each Enterprise under the ratings system adopted by FHFA in 2013. The system, known as CAMELSO, includes separate ratings for Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk, and Operations. The examination findings are also incorporated into annual Reports of Examination, which capture FHFA's view of the safety and soundness of each Enterprise's operations. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

III. FHFA's Strategic Goals and Scorecard Objectives for the Conservatorships of Fannie Mae and Freddie Mac

During 2014, FHFA defined and worked to further the objectives included in the *2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (2014 Conservatorship Strategic Plan) and the 2014 Conservatorship Scorecard.

FHFA has already published the *2015 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* (2015 Conservatorship Scorecard), which details FHFA's conservatorship expectations for the Enterprises during 2015 and builds on last year's Scorecard. Both the 2014 and 2015 Conservatorship Scorecards are centered around three strategic goals.

A. MAINTAIN, in a safe and sound manner, credit availability and foreclosure prevention activities for new and refinanced mortgages to foster liquid, efficient, competitive, and resilient national housing finance markets

FHFA's first strategic goal, MAINTAIN, requires the Enterprises to support access to credit for single-family and multifamily mortgages, as well as foreclosure prevention activities. FHFA and the Enterprises have focused on a number of objectives under this strategic goal in the last year, including clarifying the Representation and Warranty Framework, providing targeted access to credit opportunities for creditworthy borrowers, working with small and rural lenders, implementing loan modification and REO strategies in hardest hit communities, and prioritizing affordable housing through multifamily loan purchases. In the 2015 Conservatorship Scorecard, FHFA also expressed an expectation that the Enterprises address other priorities, such as assessing the reliability of and the operational feasibility of using alternate or updated credit score models.

Representation and Warranty Framework

FHFA and the Enterprises made substantial progress on updating and clarifying the Representation and Warranty Framework (Framework) during 2014, and these efforts build on the agency's work over the last several years to refine the Framework. The Framework provides Fannie Mae and Freddie Mac with remedies – such as requiring a lender to repurchase a loan – when they discover that a loan purchase does not meet their underwriting guidelines. In updating and clarifying the Framework, FHFA's objectives are to continue to support safe and sound Enterprise operations, encourage lenders to reduce their credit overlays, and complement the agency's efforts to strengthen the Enterprises' quality control process.

FHFA prioritized providing greater clarity around the life-of-loan exclusions used in the Framework during 2014, and the Enterprises announced further improvements in this area on November 20, 2014. Specifically, those changes 1) limit repurchase requests under the life-of-loan exclusions to significant matters that impact the overall credit risk of the loan; 2) modify the life-of-loan exclusions for misrepresentations and data inaccuracies to incorporate a significance test; 3) clarify the requirements for requesting repurchase related to compliance with applicable laws and regulations; and 4) provide lenders a list of unacceptable mortgage products. The changes provide all parties with greater clarity about when the life-of-loan exemptions apply and when they do not. These revisions also maintain and support safe and sound Enterprise operations and are consistent with FHFA's broader efforts to ensure that the Enterprises' place more emphasis on upfront quality control reviews and other upfront risk management practices.

Earlier in 2014, FHFA and the Enterprises also announced other Framework refinements that included revising payment history requirements, providing written notification of repurchase relief to lenders, and eliminating automatic repurchases for mortgage insurance rescissions.

We also started efforts in 2014 to develop an independent dispute resolution program that could be used as a last step, in certain circumstances, to resolve disputes between lenders and the Enterprises. This would enable lenders to challenge a repurchase request by allowing them to request a neutral third party to determine whether there was a breach of the selling representations and warranties that justifies the repurchase request. Currently, FHFA and the Enterprises are engaged in outreach activities with a variety of lenders and dispute resolution providers to solicit their input on the initial design of the dispute resolution process. Under the 2015 Conservatorship Scorecard, FHFA expects the Enterprises to finalize these improvements to the Representation and Warranty Framework in 2015.

Providing Targeted Access to Credit Opportunities for Creditworthy Borrowers

On December 8, 2014, Fannie Mae and Freddie Mac announced purchase guidelines that enable creditworthy borrowers who meet stringent criteria and can afford a mortgage, but lack the resources to pay a substantial down payment plus closing costs, to get a mortgage with a three percent down payment. These purchase guidelines will provide an important – but targeted – access to credit opportunity for creditworthy individuals and families.

To appropriately manage the Enterprises' risk, the Enterprises' purchase guidelines emphasize strong underwriting standards and do not allow the kind of risk layering that occurred in the years leading up to the housing crisis. First, the purchase guidelines for these loans include compensating factors and risk mitigants – such as housing counseling, stronger credit histories, or lower debt-to-income ratios – to evaluate a borrower's creditworthiness. Second, like other loans purchased by the Enterprises, these loans must have full documentation and cannot include 40-year or interest-only terms. Third, 97 percent LTV loans must be fixed-rate and cannot have an adjustable rate. Fourth, the products will leverage the Enterprises' existing automated underwriting systems. Finally, like other loans with down payments below 20 percent, these loans require private capital credit enhancement, such as private mortgage insurance.

The Enterprises' purchase guidelines for the 97 percent LTV loan product provide a responsible approach to improving access to credit while also furthering safe and sound lending practices. The product focuses on first-time homebuyers and requires borrowers to be owner-occupants. Both Enterprises expect to purchase only a small amount of these loans each year compared to their overall loan purchase volume, and FHFA will be monitoring the ongoing performance of these loans.

Working with Small Lenders, Rural Lenders and Housing Finance Agencies

The Enterprises have also continued efforts to work with small lenders, rural lenders, and Housing Finance Agencies (HFAs) and to strengthen their understanding of how the Enterprises might be able to better serve these entities. This work is important because we know that community-based lenders and HFAs play a vital role in serving rural and underserved markets across the country.

In the first quarter of 2014, the Enterprises issued lender guidance clarifying a number of property and appraisal requirements for dwellings in small towns and rural areas. Further, as part of its ongoing effort to serve the affordable housing market and provide liquidity to small towns and rural areas, Fannie Mae revised its Selling Guide in September 2014 to allow for the delivery of Department of Housing and Urban Development (HUD)-guaranteed Section 184 mortgages and Department of Agriculture Rural Development (RD)-guaranteed Section 502 loans as standard instead of negotiated-only products. Fannie Mae also piloted expanded partnerships with county-level HFAs which go beyond its traditional state-level approach.

FHFA expects the Enterprises to continue outreach and initiatives with small lenders, rural lenders, and HFAs in 2015, including exploring the feasibility of purchasing a greater number of manufactured housing loans that are secured by real estate.

Loss Mitigation and Foreclosure Prevention Activities

Since entering conservatorship, the Enterprises have continued to focus on loss mitigation and borrower assistance activities. As of October 31, 2014, the Enterprises had conducted nearly 3.4 million foreclosure prevention actions since the start of the conservatorships in September 2008.

The 2015 Conservatorship Scorecard provides updated expectations for the Enterprises concerning their loss mitigation and foreclosure prevention activities. This includes expectations for the Enterprises to develop and execute strategies that reduce both the number of severely aged delinquent loans and the number of vacant real estate owned (REO) properties held by the Enterprises. These efforts will leverage and build on activities over the last year, including the Neighborhood Stabilization Initiative. Through this effort, FHFA has selected the City of Detroit and Cook County, IL for pilot programs. In these areas, the Enterprises have worked to improve outcomes in hardest hit markets through developing pre-foreclosure strategies, such as deeper loan modifications, and post-foreclosure strategies that address individual properties.

The 2015 Conservatorship Scorecard expectation that the Enterprises reduce the number of seriously delinquent loans they hold will also draw upon recent experience with non-performing loan (NPLs) sales. FHFA's expectation is that the sale of seriously delinquent loans through NPL sales will result in more favorable outcomes for borrowers, while also reducing losses to the Enterprises and, therefore, to taxpayers. In 2014, Freddie Mac conducted a pilot sale of loans serviced by Bank of America that were, on average, more than three years delinquent at the time of sale. In addition, FHFA is working with both Enterprises to develop additional guidelines for ongoing NPL sales by the Enterprises, with a focus on guidelines that provide more favorable outcomes for borrowers, avoid foreclosure wherever possible and require post-sale reporting to track borrower outcomes. FHFA and the Enterprises plan to release further information about these NPL sale guidelines in early 2015.

FHFA also expects the Enterprises to continue targeted outreach activities to increase consumer awareness of the Home Affordable Refinance Program (HARP). Many borrowers could benefit from the HARP program, but may not fully understand the benefits or that they qualify. In addition, FHFA expects the Enterprises to continue refining and improving other loss mitigation and foreclosure prevention strategies. In 2014, Enterprise activities in this area included expanding the Streamlined Modification program, which addresses documentation challenges associated with traditional modifications, to include deeply delinquent loans. Moving forward, FHFA will continue to review loss mitigation options to help families stay in their homes, stabilize communities, and meet our conservatorship and EESA obligations.

Multifamily

For individuals and families who rent rather than buy, continuing to support affordable rental housing is also an ongoing priority for FHFA and the Enterprises. Fannie Mae and Freddie Mac have historically played a key role in providing financing to the multifamily housing finance market throughout all market cycles and their multifamily portfolios demonstrated strong performance even through the financial crisis.

FHFA's 2015 Conservatorship Scorecard requires each Enterprise to continue multifamily purchases, but not to exceed a volume cap of $30 billion each for these purchases. This continues the approach taken in the 2014 Conservatorship Scorecard. FHFA has also continued to emphasize the Enterprises' critical role in the affordable rental housing market by allowing the Enterprises to provide financing for affordable multifamily properties beyond the volume cap. Through this approach, the focus is to support the financing of affordable housing and the housing needs of people in rural and other underserved areas, including areas that rely heavily on manufactured housing.

On multifamily purchases, we are also requiring the companies to continue to share risk with the private sector, which Freddie Mac does through a capital markets structure and Fannie Mae does through a risk sharing model. Both approaches transfer significant risk in the multifamily business to the private market.

B. REDUCE taxpayer risk through increasing the role of private capital in the mortgage market

FHFA's second strategic goal, REDUCE, is focused on ways to bring additional private capital into the system in order to reduce taxpayer risk. This strategic goal, and the related expectations in the 2015 Conservatorship Scorecard, requires the Enterprises to reduce Fannie Mae and Freddie Mac's overall risk exposure. FHFA's objectives include ongoing requirements for the Enterprises to conduct single-family credit risk transfers, reduce each Enterprises' retained portfolio, and update private mortgage insurance eligibility requirements.

Credit Risk Transfers

FHFA and the Enterprises remain focused on increasing the amount of credit risk transferred from the Enterprises. FHFA increased the targeted levels of single-family credit risk transfers in 2014 and 2015. FHFA increased the 2014 Conservatorship Scorecard target to achieve a meaningful credit risk transfer of $90 billion in unpaid principal balance (UPB), up from $30 billion in 2013. In the 2015 Conservatorship Scorecard, FHFA increased these targets to $150 billion of UPB for Fannie Mae and $120 billion of UPB for Freddie Mac, subject to market conditions. In meeting these thresholds, FHFA will continue to expect each Enterprise to execute a minimum of two different types of credit risk transfer transactions, which includes securities-based transactions and insurance transactions. Additionally, FHFA expects all activities undertaken in fulfillment of these objectives to be conducted in a manner consistent with safety and soundness.

During 2014, the Enterprises executed credit risk transfers on single-family mortgages with a combined unpaid principal balance of over $300 billion. In each transaction, the Enterprises retained a small first-loss position in the underlying loans, sold a significant portion of the risk beyond the initial loss and then retained the catastrophic risk in the event losses exceeded the private capital support. As a result, private capital is absorbing significant credit risk on much of Fannie Mae and Freddie Mac's new purchases, thereby substantially reducing risk to taxpayers from these purchases. Both Enterprises will also continue to utilize and test different risk transfer structures.

Retained Portfolio Reductions

Both Enterprises continue to reduce the size of their retained mortgage portfolios consistent with the terms of the PSPAs, which require them to reduce their portfolios to no more than $250 billion each by 2018. Both Fannie Mae and Freddie Mac have developed plans to meet this target even under adverse market conditions. As their portfolios continue to decline, they are transferring interest rate risk, credit risk on securities and liquidity risk from these portfolios to the private sector. As of September 30, 2014, Freddie Mac's portfolio stood at $414 billion, and Fannie Mae's at $438 billion.

Under the 2015 Conservatorship Scorecard, FHFA is requiring the Enterprises to implement their approved retained portfolio reduction plans in order to meet the PSPA requirements. FHFA's guidelines require the Enterprises to implement these plans even under adverse market conditions while taking into consideration the impacts to the market, borrowers, and neighborhood stability.

Private Mortgage Insurer Eligibility Requirements

FHFA has continued to advance efforts to strengthen Fannie Mae and Freddie Mac's counterparty requirements for private mortgage insurers. When a borrower makes a down payment of less than 20 percent, these mortgages are required by statute to have a credit enhancement – private capital standing behind the loan – in order to qualify for purchase by the Enterprises. Private mortgage insurance has always played an important role in meeting this requirement and it is critical to make sure that private mortgage insurers are able to cover claims both in good times and in bad times. To this end, in 2014 FHFA released a Request for Input on draft Private Mortgage Insurer Eligibility Requirements. Our objective is to have the Enterprises strengthen their risk management by enhancing the financial, business, and operational requirements in place for their private mortgage insurer counterparties, thereby enhancing mortgage insurers' ability to pay claims over the long-term.

FHFA is in the process of reviewing and considering the public input we received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness considerations and potential impacts on access to credit and housing finance market liquidity.

C. BUILD a new single-family securitization infrastructure for use by the Enterprises and adaptable for use by other participants in the secondary market in the future

FHFA's final strategic goal is to BUILD a new infrastructure for the Enterprises' securitization functions. This includes ongoing work to develop the Common Securitization Platform (CSP) infrastructure and to improve the liquidity of Enterprise securities. FHFA has established that FHFA's first objective for the CSP is to make sure that it works for the benefit of Fannie Mae and Freddie Mac. We are also requiring that the CSP leverage the systems, software and standards used in the private sector wherever possible, which will ensure that the CSP will be adaptable for use by other secondary market actors – including private-label securities issuers – in the future. In addition, FHFA has worked with the Enterprises to leverage the CSP in order to develop a Single Security, which we believe will improve liquidity in the housing finance markets. FHFA and the Enterprises have made significant progress on both the CSP and the Single Security in the past year, and we expect the Enterprises to continue moving aggressively on these multiyear initiatives in 2015.

Common Securitization Platform

The Enterprises made important progress during 2014 in establishing the organizational infrastructure for the CSP. This includes the announcement of a Chief Executive Officer for Common Securitization Solutions (CSS) – the entity that we expect to house and operate the CSP.

In addition, FHFA and the Enterprises made considerable progress on the design-and-build phase of the CSP. Each Enterprise has designated staff to work on the project at the CSS location, and this team has been developing the technology and infrastructure of the CSP platform during the last year. This includes work to incorporate the Single Security into the development of the CSP. Furthermore, Fannie Mae and Freddie Mac have reorganized their staffs with business operations and information technology experts to develop the systems and processes needed to integrate with the CSP. As this work continues, Fannie Mae and Freddie Mac staff will engage in continuous testing and will develop operating policies and procedures to ensure a smooth transition to the CSP. FHFA, Fannie Mae, and Freddie Mac are committed to achieving a seamless CSP launch, and the actions taken so far are moving us in the right direction toward this multiyear goal.

Single Security

FHFA's top priority in pursuing the Single Security is to deepen and strengthen liquidity in the housing finance markets. In today's market, the mortgage-backed securities issued by Fannie Mae and Freddie Mac trade in separate "to-be-announced" (TBA) markets. The forward-trading that takes place in TBA securities allows borrowers to lock in a mortgage rate. The TBA market also adds efficiencies to the process, which reduce transaction costs and result in lower mortgage rates for borrowers. In today's TBA market, there is a price disparity between Fannie Mae and Freddie Mac securities largely due to greater trading volumes of Fannie Mae securities. This price disparity imposes an additional cost on Freddie Mac – and therefore on taxpayers. We believe that a Single Security can further strengthen market liquidity by reducing the trading disparities between Fannie Mae and Freddie Mac securities.

FHFA issued a Request for Input on FHFA's proposed Single Security structure last year as the first step in a multiyear process. FHFA is working with the Enterprises to process the feedback we received and will move forward in a deliberative and transparent manner. FHFA will release a Progress Report on this initiative in the coming months. As part of the 2015 Conservatorship Scorecard, FHFA established the expectation that the Enterprises would finalize the Single Security structure during 2015 and would begin the process of developing a plan to implement the Single Security in the market. This remains a multiyear process, but we made significant progress during 2014.

IV. Additional Matters and Initiatives Impacting Fannie Mae and Freddie Mac

In addition to the activities outlined above, FHFA continues to work on a number of other matters and initiatives that impact Fannie Mae and Freddie Mac, several of which are highlighted below.

Guarantee Fees

One of the first decisions I made as Director of FHFA was to suspend increases in guarantee fees that had been announced by FHFA in December of 2013. Given the impact of these fees on the Enterprises, the housing finance markets, and on borrowers, I believed that it was critical to do further evaluation and to get feedback from stakeholders. After additional assessment at FHFA, we issued a Request for Input that provided further details on how the Enterprises set these fees and posed a number of questions to prompt substantive feedback about how guarantee fee levels affect various aspects of the mortgage market.

FHFA is now reviewing and considering the input we received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness and possible impacts on access to credit and housing finance market liquidity.

Fannie Mae and Freddie Mac Housing Goals

On August 29, 2014, FHFA issued a proposed rule to set the Enterprises' housing goals for 2015 through 2017 for both single-family and multifamily loan purchases. FHFA's proposed rule raised questions for public comment about how best to set Fannie Mae and Freddie Mac's housing goals to encourage responsible lending that is done in a safe and sound manner and that also serves the single-family and rental housing needs of lower-income families as required in HERA. FHFA is in the process of evaluating comments submitted to the agency and finalizing the rule.

Housing Trust Fund and Capital Magnet Fund

Last month, FHFA directed Fannie Mae and Freddie Mac to begin setting aside funds to be allocated to the Housing Trust Fund and the Capital Magnet Fund pursuant to HERA. The statute authorized FHFA to temporarily suspend these allocations, and FHFA informed Fannie Mae and Freddie Mac of a temporary suspension on November 13, 2008. In letters sent to the Enterprises on December 11, 2014, FHFA notified Fannie Mae and Freddie Mac of the agency's decision to reverse the temporary suspension. These letters, copies of which were provided to Members of Congress who had communicated views to FHFA about whether or not the temporary suspension should continue, established prudent safeguards in the event of adverse changes in the Enterprises' financial condition or draws under the PSPAs.

Certain Super Priority Lien Programs and Risk to the Enterprises

During 2014, FHFA has continued to monitor and assess two areas of state-level actions that threaten the legal priority of single-family loans owned or guaranteed by Fannie Mae and Freddie Mac: 1) through certain energy retrofit financing programs structured as tax assessments and 2) through granting priority rights in foreclosure proceedings for homeowner associations.

While FHFA is not opposed to energy retrofit financing programs that allow homeowners to improve energy efficiency, these programs must be structured to ensure protection of the core financing for the home and, therefore, cannot undermine the first-lien status of Fannie Mae and Freddie Mac mortgages. Concerning certain energy retrofit financing programs, such as first-lien Property Assessed Clean Energy (PACE) programs, FHFA has reiterated that Fannie Mae and Freddie Mac's policies prohibit the purchase of a mortgage on property that has a first-lien PACE loan attached to it. This restriction has two potential implications for borrowers. First, a homeowner with a first-lien PACE loan cannot refinance their existing mortgage with a Fannie Mae or Freddie Mac mortgage. Second, anyone wanting to buy a home that already has a first-lien PACE loan cannot use a Fannie Mae or Freddie Mac loan for the purchase. In addition to aggressive enforcement of these existing policies, FHFA is continuing to evaluate or explore other possible remedies and legal actions to protect the Enterprises' lien position.

Additionally, FHFA has taken legal action in some instances in which unpaid homeowners association dues may be deemed under the laws of a state to be senior to preexisting mortgage liens owned or guaranteed by Fannie Mae or Freddie Mac on a homeowner's property. As conservator, FHFA has an obligation to protect Fannie Mae's and Freddie Mac's rights, and will aggressively do so.

FHFA's Actions as Regulator of the Federal Home Loan Banks

The FHLBanks continue to play an important role in housing finance by providing a reliable funding source and other services to member institutions, including smaller institutions that would otherwise have limited access to these services. In addition, the FHLBanks have specific statutory requirements related to affordable housing and, as a result, the FHLBanks annually contribute substantially toward the development of affordable housing.

I. Financial Performance and Condition of the Federal Home Loan Banks

The financial performance and condition of the FHLBank System remain strong. Led by growth in advances, the aggregate balance sheet of the FHLBanks has increased over the past two years, but remains considerably smaller than in peak years. Advances totaled $545 billion as the end of the third quarter of 2014, up from $499 billion at year-end 2013, but down approximately 50 percent from a peak of $1.01 trillion in the third quarter of 2008. The overall decline in advance volume from the peak is a result of increased market liquidity from deposits and sluggish economic growth.

Following are highlights of the financial performance of the FHLBanks:

- The FHLBanks, in aggregate, reported net income of $1.7 billion for the first three quarters of 2014 after earning $1.8 billion in the first three quarters of 2013. All twelve FHLBanks were profitable during these quarters.
- The FHLBanks saw substantial asset growth during the first nine months of 2014, driven by advances to members. As of the end of the third quarter of 2014, aggregate FHLBank assets totaled $883 billion and $545 billion in advances – up from $835 billion and $499 billion at the end of 2013. Advances constituted 62

percent of assets at the FHLBanks in aggregate at the end of the third quarter of 2014, up from 60 percent at the end of 2013.

- Retained earnings have grown significantly in recent years and totaled $13.0 billion, or 1.5 percent of assets, as of the third quarter of 2014.
- Also at the end of the third quarter of 2014, the FHLBanks had an aggregate regulatory capital ratio of 5.6 percent – comfortably above the statutory minimum of 4.0 percent.
- All FHLBanks had net asset values (equity values) in excess of the par value of their members' stock holdings. The market value of the FHLBanks was 142 percent of the par value of capital stock as of the third quarter of 2014, the highest ratio since FHFA started tracking this metric in 2002.

II. FHFA's Supervisory and Regulatory Activities Related to the FHLBanks

FHFA conducts annual safety and soundness and affordable housing program examinations of all 12 FHLBanks and the Office of Finance based on well-defined supervisory strategies. Similar to the approach utilized in supervision of the Enterprises, FHFA uses a risk-based approach to conducting supervisory examinations of the FHLBanks, which prioritizes examination activities based on the risks given practices pose to a regulated entity's safe and sound operations or to its compliance with applicable laws and regulations. FHFA's FHLBank supervision also utilizes the CAMELSO ratings system and incorporates these ratings into each FHLBanks' Report of Examination. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

Over the last few years, FHFA's supervisory work has included assessments of FHLBank mortgage purchase programs, the substantial increase in advances to a few very large member institutions, the FHLBanks' changing capital composition in light of their increasing retained earnings and reduced activity stock requirements, and their management of unsecured credit. We are also currently conducting reviews of FHLBank enterprise risk management structures and approaches to vendor management.

FHFA also provides the FHLBanks supervisory guidance in the form of Advisory Bulletins that outline the agency's regulatory expectations. In 2014, FHFA issued Advisory Bulletins 2014-02, *Operational Risk Management*, and 2014-05, *Cyber Risk Management*. Other Advisory Bulletins applicable to the FHLBanks covered areas such as model risk management, collateral valuation and management, and the classification of risky assets.

FHFA's supervision of the FHLBanks' expanding mortgage programs involves oversight of the operational issues raised by two new products – Mortgage Partner Finance (MPF) Direct and MPF Government MBS. The FHLBank of Chicago expects to begin offering these new products in early 2015, although this could change. Under MPF Direct, participating members may sell non-conforming and conforming, single-family, fixed-rate mortgage loans to the Chicago FHLBank, which would concurrently sell the loans to a third-party private investor that would accumulate the loans for securitization. The Chicago FHLBank expects, at least initially, that loans sold would be "jumbo conforming" loans capped at $729,750 for a single unit in the contiguous United States.

Under the MPF Government MBS program, the Chicago FHLBank would purchase government guaranteed or insured loans, accumulate the loans on its balance sheet as held for sale, and pool the loans in securities guaranteed by the Government National Mortgage Association (Ginnie Mae). The Chicago FHLBank would then sell the securities to other FHLBanks, members approved to participate in the mortgage programs, and external investors.

The mission focus of the FHLBank System is an important component of FHFA's regulatory activities. FHFA has undertaken three recent efforts related to the housing finance mission of the FHLBanks. First, in September 2014, FHFA released a proposed rulemaking involving membership requirements for the FHLBanks. Congress established the FHLBank System in 1932 as a government sponsored enterprise with a focus on housing finance. Over time, Congress has expanded the membership base, expanded the types of assets that are eligible collateral for advances, and made other incremental changes to the System. However, over eighty years later, the FHLBanks are still grounded in supporting housing finance.

Under the current membership rule, institutions may gain access to the benefits of FHLBank membership by meeting a one-time test showing the minimum required housing finance assets at the time of application. FHFA has proposed eliminating this one-time test and, instead, requiring that FHLBank members maintain a minimum amount of housing finance assets on an ongoing basis. In addition, FHFA has proposed defining an insurance company in such a way that captive insurers would no longer be eligible for FHLBank membership. A captive insurance company provides benefits only for its parent company, which itself is often not eligible for FHLBank membership. While captive insurers may in some cases be involved in housing finance, allowing them to have access to the FHLBank System raises a number of policy issues that are discussed in the proposed rule.

The comment period for this proposed rule ended on January 12, 2015, and we received approximately 1,300 comments. FHFA is in the process of reviewing and considering these comments. As I have consistently emphasized since becoming Director of FHFA, getting input and feedback from stakeholders is a crucial part of FHFA's policymaking process, and we will carefully consider comments made by members of this Committee as well as the public in determining our final rule.

Second, FHFA has been in continued dialogue with the FHLBanks about "core mission assets." This also relates to the fundamental issue of how the FHLBanks use the benefits of their government-sponsored status to support their housing finance and community investment mission. In partnership with the FHLBanks, I believe we are making progress in developing a framework to describe the fundamental characteristics of what a FHLBank's balance sheet should look like in order to demonstrate a satisfactory mission commitment.

FHFA's third ongoing effort related to the mission of FHLBanks is a review of FHFA's Affordable Housing Program (AHP) regulation. The AHP program provides funding for both single-family and rental affordable housing – including housing affordable to very low-income individuals and families. In 2013, the FHLBanks allocated $297 million to their AHPs for the purchase, construction, or rehabilitation of over 37,800 housing units. FHFA is committed to working with the FHLBanks to make this program more efficient by reviewing, and possibly updating, our AHP regulation.

A new area of FHFA's recent regulatory work has involved the merger of the FHLBanks of Des Moines and Seattle, which would be the first merger ever of two FHLBanks. There has been considerable change in our nation's financial system, in the membership base of the FHLBanks, and in market conditions across the various FHLBank districts since the FHLBank System was established in 1932. As a result, the FHLBanks have seen changes in advance demand and membership composition which, in turn, has affected the fundamental franchise values of some of the FHLBanks.

These changes, in part, have led the Boards of Directors of the FHLBank of Des Moines and the FHLBank of Seattle to determine that a combined entity would better serve the needs of their members. The Boards of both FHLBanks voted to approve their merger on September 25, 2014. FHFA reviewed and evaluated the merger application submitted by the FHLBanks of Des Moines and Seattle to ensure that the merger would be accomplished in a safe and sound manner and would result in a financially strong FHLBank that supports the interests of all its members. FHFA issued an approval of the merger application on December 22, 2014, contingent upon the members of both FHLBanks ratifying the merger and meeting other specified conditions. If ratified, the merger could be finalized as early as the second quarter of 2015.

Conclusion

While I have not focused in my statement on administrative matters at FHFA, I would be remiss if I did not point out that none of the activities or initiatives described in this statement would be possible without the dedication of the staff at the Federal Housing Finance Agency. Since I became Director at FHFA last year, it has been a pleasure getting to know the very qualified staff at FHFA and working with them to reevaluate and pursue FHFA's priorities. I thank them for their service. I also want to recognize the hard work of the boards, management and staffs of Fannie Mae, Freddie Mac and the FHLBanks, who continue to restore and provide critical contributions to our nation's housing finance system.

In the coming year, FHFA will continue to work to meet the agency's statutory mandates to ensure the safe and sound operations of our regulated entities and to ensure that they provide liquidity in the national housing finance market. In addition, FHFA will continue to advance its Office of Minority and Women Inclusion responsibilities, which include furthering diversity in management, employment and business activities at FHFA, as well as at our regulated entities.

Thank you again for having me here this morning, and I look forward to answering your questions.

Contacts:

Corinne Russell (202) 649-3032 / Stefanie Johnson (202) 649-3030

Statement

Statement of the Federal Housing Finance Agency on Certain Super Priority Liens

FOR IMMEDIATE RELEASE

12/22/2014

Today, the Federal Housing Finance Agency (FHFA) is alerting homeowners, financial institutions, and state authorities of the agency's concerns with state-level actions that threaten the first-lien status of single-family loans owned or guaranteed by Fannie Mae and Freddie Mac. In particular, FHFA is concerned about state actions to create super-priority liens in two instances: 1) through certain energy retrofit financing programs structured as tax assessments and 2) through granting priority rights in foreclosure proceedings for homeowner associations. In issuing this statement, FHFA is acting in furtherance of its statutory obligations as regulator and conservator of Fannie Mae and Freddie Mac.

The existence of these super-priority liens increases the risk of losses to taxpayers. Fannie Mae and Freddie Mac, while operating in conservatorship, currently support the housing finance market by purchasing, guaranteeing, and securitizing single-family mortgages. One of the bedrock principles in this process is that the mortgages supported by Fannie Mae and Freddie Mac must remain in first-lien position, meaning that they have first priority in receiving the proceeds from selling a house in foreclosure. As a result, any lien from a loan added after origination should not be able to jump in line ahead of a Fannie Mae or Freddie Mac mortgage to collect the proceeds of the sale of a foreclosed property. However, as is detailed below, FHFA is concerned by some liens being advanced to "super-priority" status over Fannie Mae and Freddie Mac first-lien mortgages.

<u>Energy Retrofit Financing Programs Structured as Tax Assessments</u>

While FHFA fully supports energy retrofit financing programs to allow homeowners to improve energy efficiency, these programs must be structured to ensure protection of the core financing for the home and, therefore, cannot undermine the first-lien status of Fannie Mae and Freddie Mac mortgages. Some entities and localities are advancing the argument that single-family energy retrofit financing programs that are structured to make loans through the homeowner's property tax assessment and require that borrowers repay their loans as part of their property tax bill should have priority over all other loans, including pre-existing Fannie Mae and Freddie Mac mortgages.1 One such program is known as the Property Assessed Clean Energy (PACE) program, which often provides loans as first-liens and is offered in California and in some other states. Localities offering these PACE loans threaten to move existing Fannie Mae and Freddie Mac mortgages to a second lien position and increase the risk of loss to the Enterprises and, by extension, to taxpayers.

In issuing this statement, FHFA wants to make clear to homeowners, lenders, other financial institutions, state officials, and the public that Fannie Mae and Freddie Mac's policies prohibit the purchase of a mortgage where the property has a first-lien PACE loan attached to it. This restriction has two potential implications for borrowers. First, a homeowner with a first-lien PACE loan cannot refinance their existing mortgage with a Fannie Mae or Freddie Mac mortgage. Second, anyone wanting to buy a home that already has a first-lien PACE loan cannot use a Fannie Mae or Freddie Mac loan for the purchase. These restrictions may reduce the marketability of the house or require the homeowner to pay off the PACE loan before selling the house.

FHFA believes it is important for states and municipalities to understand these restrictions before continuing to offer the programs. Additionally, FHFA believes that borrowers should fully understand these restrictions prior to taking out a first-lien PACE loan.

In addition to aggressive enforcement of these existing policies, FHFA is continuing to explore other possible remedies and legal actions to protect the Enterprises' lien position in response to first-lien PACE programs.

Homeowner Association Priority Status

FHFA is aware that, in certain jurisdictions, liens for unpaid homeowner association ("HOA") dues may be deemed to be senior to preexisting mortgage liens on a homeowner's property. As a result, on December 5, 2014, FHFA and Fannie Mae filed an action in federal court in Nevada, seeking a determination that a HOA's foreclosure sale is invalid and contrary to federal law to the extent that it purports to extinguish Fannie Mae's property rights. *Federal National Mortgage Association v. SFR Investments Pool 1, LLC*, No. 2:14-cv-02046 (D. Nev. December 5, 2014). FHFA has also intervened in *Saticoy Bay, LLC Series 1702 Empire Mine v. Federal National Mortgage Assoc.,* No. 2:14-cv-01975 (D. Nev.), seeking a declaration that a prior HOA foreclosure sale is invalid to the extent that it purports to extinguish Fannie Mae's property interests.

These FHFA actions are based on federal law which precludes involuntary extinguishment of liens held by Fannie Mae or Freddie Mac while they are operating in conservatorships and bars holders of other liens, including HOAs, from taking any action that would extinguish a Fannie Mae or Freddie Mac lien, security interest or other property interest. Specifically, Title 12 USC Section 4617(j)(3) states that "[no] property of the Agency shall be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Agency, nor shall any involuntary lien attach to the property of the Agency." FHFA is authorized, as conservator, to bring this suit because Enterprise lien interests in collateral constitute property protected by this provision.

FHFA has an obligation to protect Fannie Mae's and Freddie Mac's rights, and will aggressively do so by bringing actions to void foreclosures that purport to extinguish Enterprise property interests in a manner that contravenes federal law.

1 PACE financing programs can be structured as secondary liens that stand behind the original mortgage and do not threaten the priority status of Enterprise loans.

###

The Federal Housing Finance Agency regulates Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks. These government-sponsored enterprises provide more than $5.6 trillion in funding for the U.S. mortgage markets and financial institutions.

Contacts:

Stefanie Johnson (202) 649-3030 / Corinne Russell (202) 649-3032

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

May 1, 2014

The Honorable Edmund G. Brown Jr.
Governor, State of California
State Capitol
Sacramento, CA 95814

RE: California Property Assessed Clean Energy Program

Dear Governor Brown:

Thank you for your letter of April 28, 2014 about California's Property Assessed Clean Energy (PACE) program. The Federal Housing Finance Agency's (FHFA) General Counsel has been in touch with your staff, and I appreciate the time and materials they have provided concerning California's PACE program and intentions in creating the Reserve Fund.

I am writing to inform you that FHFA is not prepared to change its position on California's first-lien PACE program and will continue to prohibit the Enterprises from purchasing or refinancing mortgages that are encumbered with first-lien PACE loans. California's PACE program would allow local governments to finance energy-related home improvement projects by placing an assessment on a homeowner's property in a first lien position, resulting in the subordination of an existing Enterprise-backed mortgage to a second lien position. The effect of this is to increase the risks and possibility of losses to the Enterprises. Additionally, because these loans run with the land, the ongoing monthly assessments for PACE loans are passed on to any subsequent property owners – including after a foreclosure or other distressed sale – unless fully paid off beforehand.

In making this determination, FHFA has carefully reviewed the Reserve Fund created by the State of California and, while I appreciate that it is intended to mitigate these increased losses, it fails to offer full loss protection to the Enterprises. The Reserve Fund is not an adequate substitute for Enterprise mortgages maintaining a first lien position and FHFA also has concerns about the Reserve Fund's ongoing sustainability.

Should you wish to discuss this matter further, I would be happy to discuss alternatives to first-lien PACE programs with you.

Sincerely,

Melvin L. Watt

xc: The Honorable Barbara Boxer
The Honorable Zoe Lofgren

400 7th Street, S.W., Washington, D.C. 20024 • 202-649-3801 • 202-649-1071 (fax)

Federal Housing Finance Agency
Constitution Center
400 7th Street, S.W.
Washington, D.C. 20024
Telephone: (202) 649-3800
Facsimile: (202) 649-1071
www.fhfa.gov

May 1, 2014

VIA ELECTRONIC MAIL

Ken Alex
Senior Policy Advisor
Office of Governor Edmund G. Brown Jr.
State Capitol
Sacramento, CA 95814

RE: California Property Assessed Clean Energy Lending— Loss Reserve Plan

Dear Ken:

Thank you for the review and materials you and the team from the Treasurer's office and the Department of Energy provided to FHFA related to the $10 million reserve fund ("Reserve Fund") proposed for use when defaults lead to losses on mortgages encumbered by PACE loans.

The information you provided has been reviewed at FHFA's request by Fannie Mae and Freddie Mac ("the Enterprises") and evaluated carefully by FHFA. Following our review, I am authorized on behalf of FHFA to advise you that the Reserve Fund does not sufficiently address the risks to the Enterprises that we have previously described and that FHFA will continue our policy of not authorizing the Enterprises to purchase or refinance mortgages that are encumbered by PACE loans in a first lien position.

Thank you for your time on this matter and please contact me at 202 649 3050 if I can answer any questions.

With all best wishes, I am

Sincerely,

Alfred M. Pollard
General Counsel