FEDERAL HOUSING FINANCE AGENCY
Office of the Director

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Conference of State Bank Supervisors
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Dear Mr. Milner, Ms. Fortney, Mr. Saunders, Mr. Scheppach and Mr. Pound:

The Federal Housing Finance Agency (FHFA) regulates and oversees financial institutions that are vital to supporting our country's mortgage markets, housing policy and economic recovery– Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks).

This letter brings to your attention an emerging trend in state and local financing for residential energy efficiency home improvements. FHFA believes residential energy efficiency will help improve our use of resources and, in the long term, keep down the costs of home ownership. However, any such program must be carefully crafted to avoid unintended consequences for homeowners and lenders.

A significant feature of recently-enacted energy loan tax assessment programs ("ELTAP") is that the loan amount is repaid as part of the homeowner's real property tax assessment and the loans have superior lien status to existing first mortgages. The effect is to impair the value of first mortgages to creditors and any subsequent holder of first mortgages and, at the same time, to create risks for homeowners. For these homeowners, the central risk is that these loans create an additional potential for the loss of a home through a tax sale or foreclosure if the consumer cannot meet the extra debt burden. In addition, the ELTAPs that FHFA has reviewed appear to increase homeowner debt burdens and run counter to the goals of the President's loan modification and foreclosure prevention programs, which are vital to the stabilization of the housing markets.

Permitting ELTAP loans to take priority over existing first lien mortgages will result in consumers facing increased mortgage interest rates, more restrictive borrower underwriting standards and reductions in both the availability and size of mortgage loans in areas with such programs. In addition, jurisdictions enacting ELTAPs may not have considered fully the resources needed to prevent home improvement and loan frauds and to manage consumer complaints that would result from such programs.

ELTAPs may create risks to homeowners by increasing borrower debt payments that could cause a greater possibility of default; negative impact on the marketability of the home; reduced consumer choice if lenders determine to limit products offered in a market with ELTAP legislation; higher than conventional interest rates; high origination and application fees; and, long repayment periods which could exceed the useful life of the energy improvement. Finally, such loans may be originated in many cases by unregulated parties such as home remodeling firms.

States should consider carefully the unintended consequences of legislative proposals that tie repayment of ELTAPs to a homeowner's tax assessment. Beyond issues relating to possible systemic impact that these ELTAPs may pose to the housing finance system, the adverse impact on borrowers should be a major area for review. It would be prudent for those interested in energy improvements related to residential property to consult with federal and state financial regulators to determine the best approach to achieving desired results while avoiding loan programs that actually are adverse to homeowners.

A background sheet is attached for your reference. Please let me know if you have any questions. For additional assistance, please contact Donna Ely at (202) 414-3103 or Carolyn Huggins at (202) 414-1311.

Sincerely,

James B. Lockhart III
Director

Attachment

<u>Background on Energy Loan Tax Assessment Programs ("ELTAP")</u>

A Note on Fannie Mae, Freddie Mac, and the Federal Home Loan Banks

FHFA regulates Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks (the "GSEs").

The GSEs do not make loans directly to consumers. Fannie Mae and Freddie Mac publish underwriting standards that lenders follow in order for loans they originate to be eligible for sale to or securitization by the GSEs. These underwriting requirements are generally considered industry-wide best practices and are followed and watched closely by the broader mortgage market. The Federal Home Loan Banks provide financing for housing both by making secured loans (known as advances) which are collateralized by residential mortgage loans and by buying mortgages.

The GSE requirements include a detailed analysis of whether the borrower has the ability to repay the mortgage loan. Ability to repay is determined by review of the borrower's income, employment, consumer and other obligations. Particular attention is paid to: the borrower's total "debt-to-income" ratio (DTI); the borrower's principal, interest, taxes, and insurance obligations ("PITI"); the property's loan to value ratios (LTV). Neither the DTI nor the LTV should exceed a fixed percentage under prudent underwriting standards. The effect of the ELTAPs is that borrower's debt may be in excess of these ratios and may cause the borrower to go into default. ELTAPs do not adequately take into account whether there is sufficient equity in the property to support both the mortgage financing and the energy loans.

ELTAP Problems for Homeowners

Home Loss. Loans made pursuant to ELTAPs are made after a first mortgage is already in place. Therefore, the ELTAP alters the borrower risk profile and the borrower's ability to repay both the first mortgage and the ELTAP. In the event a homeowner fails to pay real property taxes, these amounts become a statutory first lien on the property and this could lead to the borrower losing his home as part of a tax proceeding.

Risky Loan Terms/High Fees. The ELTAP loan terms and structure represent serious risks to borrowers. The loan terms vary, but in most jurisdictions, the term of the loan is for 15-20 years, which may well exceed the useful life of the energy improvement that has been made by the borrower. In addition, some ELTAP originators charge significant fees and points on the loan. The homeowner may never realize the energy cost savings during their occupancy of the property.

Targeted Marketing. These loans may be marketed to homeowners who would not qualify for the new, total loan amount. For example, FHFA was particularly concerned by the marketing materials for one ELTAP which sought to entice borrowers who may not "qualify for a lower-interest loan through a private lender (*e.g.* home equity loan) due to less-than-excellent credit or lack of equity." Borrowers at the margin of eligibility for a mortgage would be approached to take on additional loan by a separate lending program. In short, in addition to higher fees, this marketing appear to place borrowers into a high risk loan at a time government programs are seeking to remove them from high risk loans.

Higher than Market Rates. ELTAP loan terms reviewed by FHFA, in some instances, appear to represent higher than prevailing market rates.

Limits on Financing, Refis and Sales. ELTAPs may well result in limits on financing and refinancing in certain jurisdictions because lenders are uncertain of the impact on their collateral and underwriting standards. In terms of resale, the ELTAP loan may be detrimental to the marketability of the home because the unpaid ELTAP balance transfers to the subsequent owner of the property.

Fraud. Finally, there is a great potential for fraud. For example, in one ELTAP, payments for the improvements are made directly to the contractor, not the borrower. Therefore, unscrupulous contractors could be paid before the work is completed to the satisfaction of the homeowner. In yet another ELTAP, the installer of the improvements can seek a 20-year loan for a solar energy system which the homeowner may or may not have authorized.

Impact of ELTAPs on Lenders

Poor Underwriting Process. Because the originators of ELTAPs do not assess outstanding borrower debt and past credit history, they can ignore prudent underwriting standards. The result is that lenders and governments are more likely to see borrower defaults.

Lender Avoidance of ELTAP Jurisdictions. Keeping in mind that ELTAPs are paid as part of the borrower's property taxes, when a borrower fails to pay and the property goes to tax sale, only the ELTAP is paid and all other recorded mortgages are erased. Therefore, responsible lenders will be forced to avoid such situations in order to minimize losses and to comply with regulatory standards.

Post Mortgage Closing Addition of Debt. Lenders are able to determine the amount of the property tax in effect at the time of loan closing and this amount is used to determine the borrower's PITI, as explained above. Because homeowners may obtain ELTAP loans <u>after</u> the lender has made the mortgage loan, the payment burden on the property may change dramatically after the loan has closed. Lenders have to take this risk into account in determining whether and in what fashion to make new mortgages or refis.

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