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## PACE Status Update

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The Federal Housing Finance Agency (FHFA) regulates Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks (the government-sponsored enterprises – GSEs). On July 6, 2010, FHFA and the Office of the Comptroller of the Currency (OCC) concluded that Property Assessed Clean Energy (PACE)<sup>1</sup> programs “present significant safety and soundness concerns” to the housing finance industry.<sup>2</sup>

This statement came after a year of discussions with state and federal agencies in which PACE, a novel mechanism for financing energy efficiency and renewable energy improvements, has gone from receiving support from the White House,<sup>3</sup> canonization as one of Scientific American’s “World Changing Ideas”<sup>4</sup> and legislative adoption in 24 states to questionable relevance, at least in the residential sector.

Whether PACE resumes its expansion as an innovative tool for financing energy efficiency and clean generation depends on outcomes in each of the three branches of government – discussions on a PACE pilot phase among federal agencies, litigation in federal court, and legislation in Congress – all highly uncertain. This policy brief addresses the practical impacts of these possible outcomes on existing and emerging PACE programs across the United States and potential paths forward.

### A Brief History of PACE & the Financial Regulators<sup>5</sup>

The FHFA first raised concerns about PACE in June 2009.<sup>6</sup> The agency suggested that PACE financing would increase homeowner debt burdens and “could cause a greater probability of default.”

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<sup>1</sup> Similar programs carry a variety of names: Voluntary Environmental Improvement Bond (VEIB) programs; Energy Loan Tax Assessment Programs (ELTAPs); and Energy Efficiency/Renewable Energy Contracting Assessment District (E-CAD).

<sup>2</sup> <http://www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf>

<sup>3</sup> The White House’s October 2009 Recovery Through Retrofit Report is available here:

[http://www.whitehouse.gov/assets/documents/Recovery\\_Through\\_Retrofit\\_Final\\_Report.pdf](http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf)

<sup>4</sup> <http://www.scientificamerican.com/article.cfm?id=world-changing-ideas&page=2>

<sup>5</sup> Further context for these developments is summarized in an earlier policy brief: [http://eetd.lbl.gov/EA/EMP/reports/ee-policybrief\\_031710.pdf](http://eetd.lbl.gov/EA/EMP/reports/ee-policybrief_031710.pdf)

<sup>6</sup> <http://pacenow.org/documents/FHFA%20Letter.pdf>

The agency also warned of a “possible systemic impact...to the housing finance system” and said that even non-participating homeowners could find slimmer mortgage choices and higher interest rates in areas where PACE programs are available.

White House staff led a series of interagency meetings in the fall of 2009 to determine the proper role for PACE. These meetings produced a Policy Framework for PACE Financing Programs,<sup>7</sup> which included guidance on, for example, requiring the use of qualified auditors, inspectors and contractors; targeting PACE financing to “high-value” projects and measures with the highest energy savings-to-investment ratio; and limiting financings to no more than 10% of property value and to applications whose property value clearly exceeded mortgage debt. The Policy Framework was designed to make PACE programs rigorous, durable and financially sound, in turn providing assurances to lenders and property owners. Ultimately, the Policy Framework and the Department of Energy’s more detailed Guidelines for Pilot PACE Programs,<sup>8</sup> issued in May 2010, failed to mollify the nation’s largest mortgage lenders.

## Recent Developments

In early May, the expansion of the PACE mechanism among state and local governments came to an abrupt end. Fannie Mae and Freddie Mac issued brief letters that suggested PACE violated standard mortgage provisions.<sup>9</sup> In early July, the FHFA reinforced the Fannie Mae/Freddie Mac letters with a statement regarding PACE cautioning that lenders and taxpayers faced “significant risk” from PACE assessments. The regulators concluded that property owners that participate in senior-lien residential PACE programs will violate standard mortgage provisions and trigger a mortgage default. In addition, the FHFA instructed Fannie Mae and Freddie Mac to use more restrictive mortgage underwriting standards for all borrowers in jurisdictions with PACE programs.<sup>10</sup> Those warnings – coming from the issuers or holders of more than half of the nation’s mortgages – froze and have now begun reversing the rapid expansion of PACE.

Typically, the tax liens created by assessments are senior to other obligations, like mortgages, and must be paid first in the event of foreclosure. Fannie Mae, Freddie Mac the FHFA, and other financial regulators reasoned that PACE assessments were, in effect, loans not assessments and so violated standard mortgage provisions requiring priority over any other loan.

## Possible PACE Outcomes

Since its July 6<sup>th</sup> letter, the FHFA and all financial regulators, under pressure from some members of Congress, have reengaged in discussions about possible options for responsibly moving PACE forward.<sup>11</sup> Several legal challenges to the FHFA’s actions have been filed nationwide,<sup>12</sup> and legislation

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<sup>7</sup> [http://www.whitehouse.gov/assets/documents/PACE\\_Principles.pdf](http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf)

<sup>8</sup> [http://www1.eere.energy.gov/wip/pdfs/arra\\_guidelines\\_for\\_pilot\\_pace\\_programs.pdf](http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf)

<sup>9</sup> <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2010/111006.pdf> and

<http://www.freddiemac.com/sell/guide/bulletins/pdf/1ltr050510.pdf>

<sup>10</sup> <http://www.fhfa.gov/webfiles/15884/PACESTMT7610.pdf>

<sup>11</sup> <http://www.grist.org/article/2010-07-20-fate-of-pace-clean-energy-programs-about-to-become-clearer/>

<sup>12</sup> Attorney General of California,

[http://ag.ca.gov/cms\\_attachments/press/pdfs/n1951\\_final\\_pace\\_complaint\\_&\\_exhibits\\_\(stamped\).pdf](http://ag.ca.gov/cms_attachments/press/pdfs/n1951_final_pace_complaint_&_exhibits_(stamped).pdf); Sonoma County,

has been introduced in the both the House and Senate that would strip the FHFA of its ability to alter underwriting standards for mortgages in PACE communities or with PACE assessments attached.<sup>13</sup>

While these developments may provide a long-term solution, cities, counties and states faced with close deadlines for obligating American Reinvestment and Recovery Act (ARRA) grants are already suspending or withdrawing PACE programs—including cancellation of San Francisco’s \$150 million program and the California Energy Commission’s \$30 million municipal PACE program intended to support 23 counties and 184 cities. More than a dozen communities that planned to implement PACE programs around the United States by the end of 2010 may be forced to abandon these efforts. Several early adopters of PACE – Sonoma County, CA and Babylon, NY – weighed ending their residential PACE programs but elected to continue, and some jurisdictions are proceeding with or considering commercial-only PACE programs or acceptance of a subordinated lien.

Significant uncertainty remains about PACE’s ultimate fate, and the timing of potential resolutions:

- The Administration may successfully facilitate an interagency solution that provides sufficient assurances to mortgage lenders and financial regulators;
- Congress may legislate away the FHFA’s discretion and require underwriting of mortgages consistent with existing federal PACE guidelines; or
- A federal judge may deem one of the lawsuits filed to-date sufficiently compelling to enjoin the FHFA, Fannie Mae and Freddie Mac from discouraging mortgages on properties with PACE financings.

Either of the first two outcomes might allow the re-launch and expansion of senior lien residential PACE programs (potentially with more restrictive underwriting requirements). Absent resolution by one of these avenues, PACE for the near term is likely to continue in only a few jurisdictions, with some communities resorting to commercial-only programs or subordinate-lien financings. Below, we discuss the outlook for these two PACE options.

## Outlook for Commercial PACE<sup>14</sup> <sup>15</sup>

Because commercial mortgages typically have more restrictive covenants than residential mortgages, commercial PACE programs require that property owners obtain the consent of the mortgage lenders before PACE assessments are placed on their properties. This consent requirement gives mortgage holders the right to reject lien subordination, and is generally considered to be a robust protection. However, regulators have not drawn a firm line between commercial and residential programs and

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[http://www.drivecms.com/uploads/sonomacountyenergy.org/County\\_Files\\_in\\_Federal\\_Court\\_to\\_Save\\_Innovative\\_Energy\\_Program.pdf](http://www.drivecms.com/uploads/sonomacountyenergy.org/County_Files_in_Federal_Court_to_Save_Innovative_Energy_Program.pdf), Sierra Club, [http://action.sierraclub.org/site/MessageViewer?em\\_id=183284.0](http://action.sierraclub.org/site/MessageViewer?em_id=183284.0)

<sup>13</sup> Senate Bill: S.3642 and House Resolution: H.R.5766

<sup>14</sup> Please visit the Department of Energy’s Commercial PACE Primer for more information on Commercial PACE: [http://www1.eere.energy.gov/wip/pdfs/commercial\\_pace\\_primer.pdf](http://www1.eere.energy.gov/wip/pdfs/commercial_pace_primer.pdf)

<sup>15</sup> This section is adapted from a Renewable Funding letter titled “Potential regulator issues regarding PACE commercial”. For more information on Renewable Funding, please visit: [www.renewfund.com](http://www.renewfund.com)

recent actions by the FHFA and the Office of the Comptroller of the Currency (OCC) have raised some questions about the viability of PACE programs that target properties in the commercial sector.

#### *Federal Housing Finance Agency Statement*

The July 6<sup>th</sup> FHFA letter was specific to home mortgage lending and did not directly address or challenge commercial PACE programs. However, the FHFA statement did raise potential concerns that commercial programs might run into regulator issues.

- The FHFA statement raised generic concerns about PACE that could be applied to commercial programs. For example, FHFA stated “first liens established by PACE loans are unlike routine tax assessments and pose unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors. The size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.”
- The FHFA directed Fannie Mae and Freddie Mac to take actions such as increasing mortgage lending standards in all communities that offer PACE loans. While it is assumed that the FHFA would not increase lending standards in situations where there is a commercial PACE program but no residential program, additional clarity is necessary.
- The FHFA statement directs Fannie Mae, Freddie Mac and the Home Loan Banks to both increase lending standards for entire communities AND require lender consent. This appears to undermine the position that regulators believe lender consent, by itself, is sufficient to protect lenders.

#### *Statement from the Office of the Comptroller of the Currency<sup>16</sup>*

On the same day as the FHFA statement, the Office of the Comptroller of the Currency (OCC) also issued PACE guidance. The OCC regulates national banks. This statement raised additional concerns by specifically mentioning commercial properties in its statement that “safety and soundness concerns” exist. The statement gave specific guidance regarding commercial PACE:

“National bank lenders should take steps to mitigate exposures and protect collateral positions. For existing mortgage and home equity loans, actions may include the following in accordance with applicable law:...In the case of commercial properties, securing additional collateral.”

One interpretation of this statement is that commercial lending standards may be increased throughout a community that undertakes a commercial PACE program. However, another interpretation is that it would simply require banks to carefully underwrite commercial properties that are requesting permission for a PACE lien.

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<sup>16</sup> <http://www.occ.treas.gov/ftp/bulletin/2010-25.html#footnote%23footnote>

The White House, federal agencies, and Congress are also seeking clarification from the OCC, the FHFA, and other regulators as to the acceptability of commercial PACE programs.

## Outlook for Subordinate-Lien PACE

Several states and local governments are examining or implementing subordinate-lien PACE programs. For example, the State of Maine received a \$25 million Better Buildings<sup>17</sup> grant to implement its program. Subordinate-lien PACE programs do not run afoul of the FHFA or OCC because lien holders cannot recover funds until first mortgage holders have recovered their full investment. However, the financial regulators general concerns about sufficient underwriting criteria and consumer protections must be addressed. Additionally, subordinate-lien PACE programs face a number of financing, administrative, and legislative challenges, and their ultimate feasibility and scalability is not clear.

### *Financing Challenges*

Subordinate-lien PACE programs may face significant challenges in attracting secondary market financing. Without access to low-cost private capital, the ability of these programs to scale would be limited. A 2009 Barclays Capital analysis concluded that “there would be little to no meaningful bond buyer interest in pari passu or subordinated PACE liens and therefore the PACE bond market would be highly unlikely to develop.”<sup>18 19</sup> The driver of this conclusion was that “it is highly likely that subordinated/pari passu PACE Special Assessment Bonds will be rated as non-investment grade.” There is potential that this ratings challenge may be overcome with appropriately-sized credit enhancements (e.g., loan loss reserve funds) that limit risk to the bondholder.

Based on experience to date, PACE program experience suggests that PACE assessment non-payment rates will be low. For example, communities with PACE pilot programs have non-payment rates below 1%. However, a subordinate-lien position may hinder the ability of local governments to recover PACE assessments in the event of non-payment. If a property owner fails to make subordinated PACE payments, but remains current on first mortgage payments, the local government would need to pay off the first mortgage and then proceed to foreclosure in order to recover both overdue PACE payments and the mortgage value – two extremely burdensome steps.<sup>20</sup> More likely, the local government may choose to maintain the subordinated lien on the property and force it to be paid off upon property transfer. To the extent PACE assessments support municipal revenue bonds, the absence of an efficient recovery mechanism is likely to be a significant investor concern.

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<sup>17</sup> The Retrofit Ramp-up initiative has been renamed Better Buildings. For more information, please visit: [http://apps1.eere.energy.gov/buildings/publications/pdfs/building\\_america/ns/plenary\\_3\\_betterbuildings.pdf](http://apps1.eere.energy.gov/buildings/publications/pdfs/building_america/ns/plenary_3_betterbuildings.pdf)

<sup>18</sup> Pari passu liens would have equal recovery priority to first mortgages.

<sup>19</sup> [http://pacenow.org/documents/Pace%20letter%20sept%202009%20re%20liens%20\\_2\\_%20\\_2\\_%20-%20Barclays%20%209-14-09%20\\_3\\_.pdf](http://pacenow.org/documents/Pace%20letter%20sept%202009%20re%20liens%20_2_%20_2_%20-%20Barclays%20%209-14-09%20_3_.pdf)

<sup>20</sup> For more information on how senior PACE assessment non-payment is typically handled, please visit: [http://eetd.lbl.gov/ea/EMS/reports/ee-policybrief\\_050410.pdf](http://eetd.lbl.gov/ea/EMS/reports/ee-policybrief_050410.pdf)

### *Administrative Challenges*

Senior-lien PACE special assessments are attractive to local governments because payment collection can be easily integrated into existing tax collection infrastructure. New procedures and collection mechanisms may be required for managing the tax collections for subordinate tax liens.<sup>21</sup> This additional administrative burden threatens to make PACE programs more expensive and to decrease the attractiveness of this financing tool to local governments. Programs may choose to avoid part of the tax collection issue by issuing a separate bill to property owners, but in the event of PACE non-payment they will still have to work with local tax authorities to place a subordinated lien on the delinquent property.

### *Legislative Challenges*

While 24 states have passed PACE enabling legislation, many of those statutes explicitly declare that PACE assessments create *senior* property liens. Several states may require legislative amendments to existing PACE authority to allow subordinate-lien PACE special assessment districts.<sup>22</sup> Program developers should check with relevant legal and tax authorities to assess whether subordinate-lien PACE programs are allowed under their state's PACE statute.

## **Conclusion**

The Department of Energy (DOE) recently released a Status Update for Pilot PACE Financing Programs.<sup>23</sup> The statement noted that:

The DOE and Administration continue to support pilot PACE financing programs. Recovery Act grantees are not expressly prohibited from using funds to support viable PACE financing programs, however the practical reality is that residential PACE financing programs with a senior lien priority face substantial implementation challenges in the current regulatory environment. In light of the clear opposition from the regulators for PACE financing programs with a senior lien priority, prudent management of the Recovery Act compels DOE and Recovery Act grantees to consider alternatives to programs in which the PACE assessment is given a senior lien priority.

As states and local governments await potential legal, legislative, or regulatory PACE solutions, commercial PACE and subordinate-lien PACE programs may provide a path forward. However, as this policy brief has outlined, these potential program options also face a number of challenges.

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<sup>21</sup> Please visit the Barclays Capital analysis (footnote 18) for more information on collection issues that may arise.

<sup>22</sup> Please visit the PACE How-To Guide for more information on setting up PACE programs:

<http://rael.berkeley.edu/financing/resources>

<sup>23</sup> <http://www1.eere.energy.gov/wip/pace.html>