# Role of Existing Lenders in Commercial and Industrial PACE

Property Assessed Clean Energy (PACE) laws allow municipalities to establish programs under which property owners can borrow money for energy efficiency improvements, renewable energy systems and/or water conservation, and repay the money through a property tax assessment. Money previously used for utility bills is redirected to pay for capital asset improvements to the property. Reductions in utility bills more than offset the property tax increase. PACE assessments are on par with liens securing general property taxes and are senior to mortgages.

For Commercial and Industrial PACE programs presently gearing up around the country, a key question for the states, counties and cities ready to create the PACE Special Improvement Districts is whether or not to grant lenders holding mortgages on properties within the Districts a right to approve or disapprove PACE improvements to those properties. The factors described in this paper should be taken into account by states and local jurisdictions, which have the decision authority.

First, the fundamental underpinning of PACE is the right of municipalities to determine what improvements are in the public interest, and therefore are entitled to the security of going on the property tax roll. This 100 year old constitutional authority of municipalities is the basis for a city's right to replace leaky sewer lines with new pipes and repay that cost via property tax assessment. Before a PACE District can be created, a municipality within a state which has passed PACE enabling legislation must make the determination that replacing fossil energy with clean energy is in the public interest. Once that determination has been made, then the question of whether to treat lenders any differently on PACE assessments than they are treated on sewer assessments is entirely up to the jurisdiction that made the determination.

Under the state laws enabling PACE, the maximum assessment amount is limited to 10% of the property's value, and acceleration of principal in the event of a default is prohibited. If tax payments are delinquent and action to collect is taken, only the delinquent amount plus penalties and interest is collectible. Most states allow assessment amortization schedules of 20 years. In the event of a default, then, the maximum amount due on a PACE assessment is $1/20^{th}$ of the original assessment, which itself is limited to $1/10^{th}$ of the property's value. Thus, the burden on the property is never more than 0.5% ($1/200^{th}$) of its value. Insofar as a lender's question about PACE being senior to the mortgage is concerned, the actual amount that is senior is immaterial.

Under responsible program underwriting standards, PACE improvements to C&I properties result in a positive net cash flow following the improvement, as compared to the pre-improvement condition. The basic criterion for a C&I PACE project is that its utility bill must go down more than its tax bill goes up. This calculation is referred to as the Savings to Investment Ratio being greater than one (SIR>1). The metric which lenders use in determining whether or not to approve a commercial mortgage is the "debt coverage ratio," which quantifies the relationship of the Net Operating Income (NOI) to the debt service payments on the mortgage. By definition, an SIR>1 increases the Net Operating Income. Any increase in the NOI improves the debt coverage ratio. The property owner's cash flow is increased and his ability to pay the mortgage is enhanced. Thus, any lender's security on a mortgage is improved by a PACE project done to the property after the original mortgage was placed.

Underlying the security analysis is a key fact too often overlooked in lender discussions: *utility bills are already senior to mortgages, and always will be*. Without power, buildings are also without value. Failure to pay the utility bill quickly results in loss of power to the building. Loss of power means loss of value until power is restored. In contrast, failure to pay the mortgage results in a very slow process that, while involving costs, does not, in itself, result in loss of value. Accordingly, in a PACE program, municipalities and lenders must first understand that they are dealing exclusively with a cash flow that is effectively senior to mortgages prior to the assessment as well as after the assessment. The key question then is whether the property's net position improves. Adopting an SIR>1 standard as part of the underwriting criteria in a PACE district assures that both the lender's and the property owner's net economic condition is better after the clean energy improvements than before.

Since the PACE amount due in the event of foreclosure is immaterial insofar as the mortgage holder is concerned, and since the debt coverage ratio is improved through redirection of an already senior cash flow, there is no legitimate economic basis for a lender to oppose PACE projects observing responsible underwriting standards. In view of that fact, jurisdictions contemplating policy decisions on whether to provide lenders with notice that a PACE project is being done, or to grant lenders a right to block PACE projects, should consider some additional factors.

If a jurisdiction creates a requirement that PACE projects must receive explicit consent or written approval from existing lenders, that requirement places bankers in a bind which pits the bank against the public interest. The bind is that a banker granting explicit approval to the placement of a tax assessment risks placing that bank at odds with the regulators to whom it answers. Since lenders have no authority to approve or disapprove tax assessments in general, by requiring specific consent to PACE assessments, the jurisdiction forces the banker to treat the tax assessment as if it were a regular loan. In so doing, the jurisdiction is asking the banker to both perform a credit analysis on the borrower and to violate regulations often governing placement of the original mortgage, if he is to approve the PACE project. Under those circumstances, the banker will decline the approval, thereby thwarting the public purpose for which the District was created in the first place.

Under those conditions, the only action available to a banker who supports the public purpose of replacing fossil energy with clean energy is to attempt to make a PACE loan on the property himself. This places the municipality in the odd position of granting to bankers exclusive control over the rate at which properties in the jurisdiction are able to use financing as a tool to reduce their energy consumption or replace fossil energy with clean energy. Since properly financed energy efficiency is already far less expensive than fossil energy, private property retrofits would already be the norm in every community if banks were either willing or capable of financing them.

As has been noted and documented[1], PACE is a massive jobs program with enormous economic growth value that is 100% privately financed. Local jurisdictions would not, as a conscious policy, want to seriously impede the scale and speed at which local contractors and businesses are able to capture the cash flow presently being spent on fossil fuels, frequently going right through the roof of highly wasteful buildings. By requiring explicit lender consent for PACE improvements, instead of simply requiring notice, some jurisdictions may inadvertently cause the same damage to their contractors and businesses.

In light of the lack of economic or legal merit for a lender consent requirement, and in view the negative jobs impact it would cause, the question naturally arises as to why any jurisdictions are contemplating it. The answer is that many just stopped serious consideration of the relevant factors once told that PACE assessments are senior to mortgages. Lenders generally oppose the idea of any financial obligation going senior to the one they hold. Failure to consider the factors described above confines the thinking to simple opposition to seniority of any type.

When lender opposition is conveyed to elected officials, political solutions are often sought. At first blush, the idea of granting bankers the right to approve or disapprove seems like a reasonable political compromise in order to avoid opposition. However, PACE is far too powerful in its jobs, economic and environmental benefits to be given only a first blush analysis.

In deciding whether the policy with respect to lenders should be a requirement of notice, or a requirement for explicit consent, jurisdictions should be clear that requiring explicit consent is a strictly political consideration, without economic merit, which runs directly counter to the public's interest.

1 ECONorthwest study "Economic Impact Analysis of Property Assessed Clean Energy Programs (PACE), April 2011.