



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

October 1, 2010

The Honorable Edwin G. Perlmutter
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I thank you for the opportunity in the last months to work with you and your staff, as well as other members of Congress and the administration, to discuss the Property Assessed Clean Energy (PACE) program, an initiative to promote energy efficiency and renewable energy improvements for residential and commercial properties.¹ As you know, PACE has received financial support from the U.S. Department of Energy (DOE) through grants to states and municipalities. While details vary across individual PACE programs, as a general matter, state and/or local governments provide funding for improvements, with repayment taking place through the property tax assessment process. As outlined below, we believe that such programs could be improved through enhancements related to consumer protection, underwriting, and lien priority.

Consumer Protection

One key lesson from the home equity lending abuses of the 1990s and the recent mortgage crisis is the need to provide safeguards to ensure that consumers fully understand the associated terms and risks of credit products. As with any program that involves consumer transactions, energy retrofit programs, including PACE, should have effective consumer protection safeguards in place, including uniform, adequate, and clear disclosures that promote informed decision-making by consumers. PACE program disclosures should make consumers aware that inability to repay PACE advances could result in the loss of their home and that, given the priority lien status of PACE, failure to make PACE payments might constitute an event of default on their existing mortgage loans. Further, consumers should be advised that other private and government-sponsored financing options exist for energy-efficient home improvements.

Transactions wherein a creditor extends consumer credit are generally subject to the Truth in Lending Act (TILA) and the Board's Regulation Z, which implements

¹ For the purposes of this statement, financing for energy improvements through special tax assessments will be referred to as "PACE" but could include other programs with similar core features.

TILA.² TILA seeks to promote the informed use of consumer credit by requiring disclosures about terms and costs. Moreover, additional disclosures and protections, such as the consumer's right to rescind the transaction, apply to credit that is secured by a consumer's dwelling. Special rules also apply to higher-priced loans secured by the consumer's principal dwelling. These consumer protections under TILA may not be triggered by all PACE programs because some municipalities may fund the programs through tax assessments that may not be extensions of credit covered by TILA. For those programs, the Board believes that basic consumer disclosures and protections similar to those required by TILA are appropriate.

DOE recently issued best practices guidelines³ that highlighted some consumer protection, consumer education, quality assurance, and anti-fraud features as best practices. We believe guidelines are an important first step to protect consumers. Additional disclosures and protections comparable to those that a consumer would receive in connection with a mortgage or consumer loan subject to TILA would be a beneficial improvement to the program. Moreover, the creation of common, required practices and procedures within the various participating jurisdictions engaging in PACE-like programs would increase the ability of the financial institution regulatory agencies, including the Federal Reserve, to analyze, and appropriately respond to, the implications of individual programs for supervised institutions.

Underwriting Standards

DOE's current best practices guidelines highlight some important elements of appropriate underwriting; however, stronger underwriting practices that analyze whether the borrower has the ability to repay the obligation would further promote safe and sound practices, thereby protecting both the borrower and existing lien holders. Examples of practices that could be added to PACE programs -- and would be part of prudent underwriting in other contexts -- include verifying whether the consumer has the ability to repay, the consumer's current and expected income, employment status, and assets other than the collateral, as inputs to the underwriting decision. In addition, stronger protections and underwriting would analyze the consumer's mortgage-related obligations, including taxes and required insurance premiums, and other debt service obligations, as well as the consumer's credit history. It is also helpful to know the collateral's current value and the estimated energy savings.

² Truth in Lending Act, 12 USC 1601 et. seq; Regulation Z, 12 CFR Part 226.

³ Department of Energy, "Guidelines for Pilot PACE Financing Programs," May 7, 2010.

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Lien priority

PACE financings typically have a priority senior lien on a consumer's residential property, similar to a tax obligation, superseding the interests of first and junior mortgage lien holders. This lien priority has the potential to impact the collateral position of existing mortgagees and investors in mortgage-backed securities. Although the PACE program itself may be small at present, introducing this superior lien obligation may cause lenders to re-evaluate the riskiness of their mortgage portfolios. This may result in restructuring and reducing credit to homeowners as institutions seek to ensure that each mortgage credit is repaid.

We look forward to continuing our discussions.

Sincerely,

A handwritten signature in black ink, appearing to be 'E. G. Perlmutter', written in a cursive style.