

Existing Lender Notification or Consent for Commercial PACE Programs

There is currently a division of thought among PACE stakeholders about whether a commercial property owner (CPO) intent on using PACE should be required to obtain consent from its existing mortgage lender or instead provide notice to the lender and receive acknowledgment of its receipt from that lender. This memo attempts to summarize the arguments for one approach versus the other.

Both sides would probably agree that an existing lender's decision to favor or oppose a PACE financed project will rest on how it weighs a number of factors including:

- The extent to which the property is leveraged (its LTV).
- How much the proposed project will improve building cash flow, its overall economics, and therefore, its value.
- Its business relationship with the property owner, i.e. the client relationship.
- An evaluation of the core business purpose of the property and its confidence in the future strength of that business
- The lender's wherewithal to sufficiently evaluate a new finance structure such as PACE

Arguments for Consent

Those who favor explicit consent from an existing lender point to the following:

1. The relationship between CPOs and their lenders is likely to be more complex than those between home owners and residential market lenders. CPOs will be leery of forcing reluctant lenders to accept PACE liens, even if it is their right to do so, because alienating an important lender may limit access to funds needed for other business purposes. Requiring consent, as a practical matter therefore, makes good business sense.
2. Commercial mortgages often include specific clauses that prohibit a CPO from voluntarily encumbering a property with debt that is senior, or even junior, to that of the existing first mortgage holder. While PACE may be a valid assessment, it is certainly a voluntary one.
3. Municipalities sponsoring programs (and property owners) must consider the possibility that existing lenders who may have been properly "noticed" but have not given consent will litigate their lien rights at any point during the assessment's life and independent of the property's financial condition. This could have profound legal and financial implications for owners and present serious political risks for the governments that promote and implement such programs.
4. The Office of the Comptroller of the Currency, a division of the U.S. Treasury, issued a statement on July 6, 2010, which included the following:

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:

- Procuring loss guarantees from the respective states or municipalities;
- Escrowing tax assessment-related debt service payments;
- Re-evaluating and adjusting home equity line of credit (HELOC) line amounts;
- and

- In the case of commercial properties, securing additional collateral.

For new mortgage and home equity loans, mitigating steps may include:

- Reducing real estate loan-to-value limits to reflect maximum advance rates of PACE programs to the extent they create super-senior lien priorities; and
- Considering the maximum amount of the PACE payment portion of the annual tax assessment in the institution's analysis of the borrower's financial capacity.

In addition, banks that invest in mortgage backed securities or that are considering the purchase of pools of mortgage loans should consider the impact of tax-assessed energy advances on their asset valuations. Finally, the OCC expects investment banking units to be cognizant of the impact of this type of funding vehicle on their respective institutions and on the mortgage market overall when making any decisions regarding associated bond underwriting.

The OCC supports commercial and residential energy lending when such lending programs observe existing lien preference, ensure prudent underwriting, and comply with appropriate consumer protections. Programs that fail to comply with these expectations pose significant regulatory and safety and soundness concerns.

Earlier this year, PACENow sought clarification from the OCC on the points in its statement that were specifically directed at commercial PACE. In a phone discussion with Tim Long (then, the OCC's Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner and author of the July 6, 2010 statement), we were told unequivocally that the OCC does not recognize the validity of PACE assessments. He said, just as clearly, that their statement was not "proscriptive", given that commercial PACE programs were voluntary and consent was required from the existing lender. Mr. Long indicated that the OCC was not inclined to micro-manage banks, but that it reserves the right to take more forceful action if it feels it is warranted.

If banks have no ability to reject a PACE assessment, it may be difficult or impossible for them to adhere to the OCC's advice that they protect their collateral positions or otherwise comply with OCC expectations. Lenders that are already leery of PACE may welcome or actively encourage OCC action to stop commercial PACE programs if they have no complete right to give or withhold consent, under a timeline that is most convenient for them. The greatest concern is that the OCC will take decisive action to ban commercial PACE programs.

5. Lender consent was provided by a mix of national, regional, and local banks for 41 completed PACE projects (primarily in Sonoma County, CA and Boulder County, CO), according to a report released by Lawrence Berkeley National Lab, Clinton Climate Initiative, and Renewable Funding in March 2011.
6. The PACE Assessment Protection Act of 2011 (HR 2599), as introduced in the House, mandates "authorization" from existing lenders for PACE commercial programs, reflecting Financial Service Committee concerns regarding lending institutions' exposure to PACE.

Arguments for Notice

Those in favor of requiring that a CPO need only provide notice and receive acknowledgment of that notice make the following arguments:

1. PACE is a valid public benefit assessment, it is the right of state and local governments to offer PACE financing, and there is no reason to treat PACE assessments any differently

than other valid assessments. Thus, it is a state and local rights issue and that right should prevail against the rights of existing private lien holders on properties.

2. Banks have inadequate incentives to provide consent, and consent decisions may end up being made by less senior and/or risk averse staff, regardless of the merits. Requiring lender consent takes a key negotiating stance off the table for property owners.
3. Supporters of notice report that banks are, in fact (and one assumes arbitrarily), withholding their consent from proposed projects. Requiring lender consent will, therefore, be a substantial impediment to achieving substantial scale for PACE.
4. Supporters of notice assert that banks that are willing to provide consent actually prefer the notice and acknowledgment construct. Some banks are said to have expressed a concern that providing consent may create problems for them with their regulators.
5. Acknowledgment of the notice of intent to implement a PACE project will provide existing lenders with an opportunity to object to that project. Presumably, a CPO will proceed only if its lender's concerns can be addressed (i.e. a CPO will not want to endanger its relationship with an important source of additional capital).
6. Consent will be difficult or impossible to obtain for properties whose mortgages have been securitized and sold to multiple downstream investors.
7. "Validation" or "Estoppel" methods may be used to establish the legality of an action in most if not all states. In the context of PACE, a validation in specific states (e.g. Florida and California) could establish the validity of the PACE assessment and its standing as a lien that is senior to mortgages. Notice proponents assert that mortgage lenders who challenge valid tax assessments never win those cases, and that lending banks that suggest they will litigate over valid PACE assessments are bluffing.
8. Regarding the risk of OCC action, notice proponents suggest that the OCC will not interfere with commercial PACE programs, despite its July 6th 2010 statement. One contention is that the OCC has no standing to do so. Another is that given the current economic and job climate, this branch of the Treasury will not want to be seen as hindering the job potential that PACE supports.

PACENow does not yet have a formal policy making body. All PACE supporters are united in the view that PACE assessments are a valid means of achieving clear national, state, and local goals for energy efficiency. Consent for commercial PACE has, in some sense, been the established standard, though the marketplace is still nascent. Those favoring notice make a number of assertions that conflict with known positions of mortgage lenders and banks. Changing the lender consent provision to a notice/acknowledgment provision in the pending federal legislation would likely require that minimum underwriting/eligibility requirements for commercial PACE programs be articulated.

PACENOW intends to work with all relevant stakeholders, including banks, to find a resolution to this issue acceptable to all parties.

At a minimum, the following questions need answers, as opposed to blanket assertions:

1. Can existing lender consent strategies be devised to ensure that a meaningful percentage of projects will receive consent?
2. Notice/acknowledgment without consent suggests that some PACE financed projects could be completed despite the objections of the existing lender. What is the likelihood that mortgage lenders will not take legal action in these instances?

3. How do lenders feel about notice/acknowledgment? What will keep them from refusing to finance or refinance properties with PACE assessments?
4. Are CPOs who voluntarily accept municipal assessments protected (by some legal precedence) from lawsuits if the terms of their mortgages expressly prohibit?
5. Is the OCC really powerless to prevent PACE, and if so, what is the likelihood that banks will choose to ignore a clear rejection of PACE by their regulator?