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Policy Brief
Four Challenges for Commercial PACE Programs
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Executive Summary

The property-assessed clean energy (PACE) model is a relatively new mechanism for financing energy efficiency and renewable energy improvements on private property with repayment through the property tax system. A number of commercial PACE programs are under development across the country.

As programs are being developed, there are four key issues that should be understood by local governments and others.

1. Regulators have taken strong action to prevent the growth of residential PACE programs. To date, their actions on commercial PACE have been more modest, but regulatory risk remains.
2. There is significant debate regarding the approach toward existing commercial mortgage holders. Most PACE laws provide that the lien securing the PACE assessment or tax is senior to pre-existing private liens. However, many commercial loan documents prohibit the property owner/borrower from creating new liens; creation of a PACE lien may be an event of default under those documents. Some new programs are planning to move forward without requiring the property owner to obtain consent from its pre-existing private lenders, but this imposes significant legal risks on the property owner and political risks on the PACE issuer.
3. A number of commercial PACE financing entities are planning to aggregate pools of PACE bonds for eventual resale or securitization. However, securities law may prevent this activity.
4. Local governments are choosing whether to provide financing entities with exclusive rights to finance PACE projects in their jurisdiction in exchange for administrative services at no direct costs to the local government. Other local governments are opting for a more open market approach. There are significant pros and cons associated with this choice.

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Introduction

The property-assessed clean energy (PACE) model is a relatively new mechanism for financing energy efficiency and renewable energy improvements on private property—commercial or residential. PACE programs allow local governments, when authorized by state law, to fund energy improvements on commercial and residential properties.

PACE financing for clean energy projects allows a property owner to implement improvements without a large up-front cash payment. The property owners that voluntarily choose to participate in a PACE program repay their improvement costs over a set time period—typically 10 to 20 years—through property assessments, which are secured by the property itself and paid as an addition to the owners' property tax bills. Nonpayment generally results in the same repercussions as the failure to pay any other property tax.

A PACE assessment is an obligation of the property, meaning the debt is tied to the property as opposed to the property owner(s), so the repayment obligation transfers with property ownership. This eliminates a key disincentive to investing in energy improvements whereby property owners are hesitant to make property improvements if they think they may not stay in the property long enough for the resulting savings to cover the upfront costs.

Residential PACE programs have received considerable attention and regulatory scrutiny. Regulatory pronouncements from the Federal Housing Finance Agency (FHFA) caused many residential PACE programs to suspend operations, but there is significant interest around the country in moving forward with Commercial PACE programs. A number of programs are underway or in advanced planning. Market research indicates a substantial potential market if the program can be standardized and brought to scale.

However, there are four major policy and legal issues confronting local and state governments as they work to develop PACE programs. This memo briefly outlines those issues.

1. Regulatory Risk

In the summer of 2010, federal regulators took action to stop residential PACE programs. The regulatory actions, which included authorization to Fannie Mae and Freddie Mac to redline entire communities that offer PACE (i.e., increase Debt to Income ratios or require higher downpayments), were mostly limited to residential programs. However, the regulatory entities have clearly indicated their concerns regarding commercial programs both formally and informally.

Office of Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) issued PACE guidance. The

OCC, which regulates national banks and foreign banks operating in the United States, included commercial projects in its statement that PACE creates “safety and soundness concerns” for the banking system. Their statement indicated that “national bank lenders should take steps to mitigate exposures and protect collateral positions.... In the case of commercial properties, securing additional collateral.”

The OCC has declined to clarify this statement publicly. However, in informal discussions, OCC staff indicated that they remain opposed to the seniority of PACE liens and will monitor their regulated entities carefully. The OCC did not suggest it will take immediate further action, but certainly left the option open.

Federal Home Loan Banks

More recently, a Federal Home Loan Bank representative notified at least one community working on PACE that additional actions were being taken that impact the commercial market. The Federal Home Loan Banks are U.S. sponsored institutions that provide stable, low-cost funding to U.S. financial institutions for mortgage loans, small business loans, and other economic development lending. As collateral for that funding, the Federal Home Loan Banks accept real estate loan pools. However, the Bank representative indicated that any commercial or residential properties with a PACE lien will be ineligible for inclusion in the pools and therefore cannot be used as collateral.

The Federal Home Loan Banks play a significant role in providing capital to smaller and regional banks and access the capital markets on a daily basis. Their position may be problematic in several ways; perhaps most notably by restricting lenders’ ability to give consent and/or by setting a precedent for other capital markets transactions.

In summary, a number of regulatory entities have taken an interest in commercial PACE. To date, key agencies such as the OCC have indicated that they have no intention of providing an overarching regulatory approval for commercial PACE regardless of underwriting or other protections. However, under existing guidance there is currently a pathway that would allow commercial PACE programs to move forward, particularly if all program administrators and sponsors proceed cautiously and with strong protections for all parties.

2. Mortgage Lender Consent

All currently operating commercial PACE programs require the affirmative consent or signed acknowledgement of existing mortgage lenders. There is some debate as to whether programs should require this step, simply ensure lenders have been notified, or require no action. Some upcoming programs have indicated plans to move forward without affirmative consent or acknowledgement of existing mortgage lenders.

The consent requirement has been documented in a number of articles and papers on commercial PACE.

“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.”

– Update on PACE programs from Lawrence Berkeley National Laboratory (August 2010)

“There are some current safeguards for lenders, such as provisions in non-residential loan documents declaring an event of default if the borrow further encumbers the property with a further loan and mortgage or deed of trust. These kinds of due-on-further-encumbrance provisions should be enforceable to prohibit AB811 loans’ assessment liens, assuming they are properly drafted.”

-- California Real Estate Journal (Jan 26, 2009)

The language in commercial mortgages tends to be strongly worded to protect the lender. These protections relate to both the lien and the improvements to the property. For example, one sample mortgage contract – for a large credit-worthy property with a mortgage from a national lender – included several provisions that would appear to require the lender grant consent. Excerpts from those provisions are included below:

Material Adverse Change: “The income and expenses of the Property, the occupancy thereof, and all other features of the transaction shall be as represented to Lender without material adverse change.... Material adverse effect shall mean any event having a material adverse effect on... the perfection or priority of any lien created under the security instrument.”

Taxes and Other Charges: “Borrower shall not suffer and shall promptly cause to be repaid and discharged any Lien or charge whatsoever which may be or become a Lien or charge against the Property, and shall promptly pay for all utility services provided to the Property.”

Alterations: “Borrower shall obtain Lender’s prior consent to any alterations to any Improvements, which consent shall not be unreasonably withheld, conditioned, or delayed, except with respect to any alterations to any Improvements which may have a material effect on Borrower’s financial condition, the value of the Property or the Net Operating Income.”

In addition, form Fannie Mae and Freddie Mac deeds of trust appear to require lender consent. Fannie Mae and Freddie Mac guarantee loans for multifamily (apartment) buildings in securities issuances and provide credit enhancement on multifamily housing bonds. Fannie Mae also purchases loans through its Delegated Underwriting and Servicing (DUS) system. According to Fannie Mae, it has provided

financing on nearly 4 million of the estimated total 15.2 million occupied multifamily units in the U.S.

The Fannie Mae form Multifamily Deed of Trust has a provision entitled “No Other Indebtedness and Mezzanine Financing” which states: “Other than the Mortgage Loan, Borrower shall not incur or be obligated at any time with respect to any loan or other indebtedness in connection with or secured by the Mortgaged Property.” The Fannie Mae form Loan and Security Agreement also has a provision entitled “Liens; Encumbrances” that appears to explicitly refer to PACE.

“Other than Permitted Encumbrances and the lien of the Security Instrument and this Loan Agreement, Borrower shall not permit the grant, creation or existence of any Lien, whether voluntary, involuntary or by operation of law, on all or any portion of the Mortgaged Property (including any voluntary, elective or non-compulsory tax lien or assignment pursuant to a voluntary, elective or non-compulsory special tax district or similar regime).”

For these reasons, the proposed federal legislation to restore PACE programs (HR 2599) currently includes a provision requiring that the proposed law only offer federal protections to PACE programs that receive authorization from the mortgage holder.

REQUIREMENTS APPLICABLE ONLY TO NON-RESIDENTIAL PROPERTY.—A PACE program shall provide, with respect to non-residential property, for the following: (1) AUTHORIZATION BY LIENHOLDERS.—Before entering into a PACE agreement with a local government or voting in favor of PACE assessments in the manner specified by State law, the property owner shall obtain written authorization from the holders of the first mortgage on the property.

However, there has been significant recent discussion as to whether PACE programs should require affirmative approvals by mortgage holders, simply require that property owners be notified of the potential risk and confirm that they sent notice to the primary lien holder, or require no action. In most states, there is no legal obligation for PACE programs to obtain consent. Legislation in the State of Florida prohibits mortgage holders from exercising default provisions because of the PACE lien.

The purpose of a consent requirement is twofold. First, by requiring lender consent, PACE programs will help property owner/participants avoid inadvertently triggering a mortgage default, which would not only adversely affect property owner/participants, but could generate bad publicity for PACE and could pull the local government into litigation. Second, consent requirements may help prevent adverse action from federal regulators or from banks themselves. Informally, a number of banks have indicated that they would pursue litigation and take other measures if programs moved forward without consent requirements.

The ultimate decision of how to navigate the issue of consent is up to local governments. Without question, consent requirements will reduce demand for PACE financing. In research done in early 2011, it appears that approximately half of consent requests were granted. Those granting consent included local, regional, and national banks.

Local governments should decide whether to require lender consent based on a full analysis of the risks to themselves, to participating property owners, and to PACE more generally. Regardless of the path chosen, a national standard used by all programs would be far preferable to a patchwork of different rules.

3. Securities Law

A number of entities looking to finance commercial PACE projects intend to aggregate and securitize pools of individual PACE bonds. However, a significant securities law issue has emerged that may present a hurdle to that plan.

The sale of PACE bonds by a local government issuer are governed by Rule 15c2-12, which was promulgated under the Securities Exchange Act of 1934 by the Securities and Exchange Commission (SEC). As a result, bonds sold to an investor must either 1) comply with certain initial and continuing disclosure requirements (which would impose potentially large and prohibitive costs on a property-by-property PACE financing) or 2) meet an exemption from the Rule. The exemption would require that the securities be purchased by no more than 35 persons, each of whom (i) “has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment” and (ii) is “not purchasing for more than one account or with a view to distributing the securities.”

To date, all local governments that have undertaken programs that permit property-by-property commercial PACE transactions have utilized the exemption to the Rule and required investors to acknowledge that they satisfy the exemption.

Capital providers intent on securitizing the PACE bonds they purchase have raised significant concerns that they may not be able to represent that they are not purchasing with a view to distribute the PACE bonds within the meaning of Rule 15c2-12.

However, many PACE issuers and investors believe that Rule 15c2-12 should not limit the securitization of PACE bonds because (i) the securitization does not involve the sale of the PACE bonds themselves to investors (the securities sold by the PACE investors will be new “asset backed securities”) and (ii) the sale of the asset backed securities must comply with a separate set of federal securities laws. Efforts are underway by PACE investors to request confirmation from the SEC that Rule 15c2-12 does not prohibit the securitization of PACE bonds sold pursuant to the exemption from Rule 15c2-12, however it will likely take 3-6 months.

4. Programmatic Approach

Local governments interested in pursuing PACE are generally choosing whether to run the programs in-house or to contract out for administrative and other services. Of particular note, local government sponsors are also choosing whether to enter exclusive long-term contracts with financing entities. There are significant pros and cons associated with this policy choice.

Closed Market Approach. Under the “closed market” approach, a local government enters into a financing and administrative services agreement with a single firm. The firm generally provides administrative services to run the program at little or no direct cost to the local government. In exchange, the local government provides the firm with the exclusive right to provide commercial PACE financing in the community for a period of years.

- **Advantages.** First, given the nascent stage of PACE financing, it can help ensure that at least one financing source is available in a particular community. Second, a local government can set up a program at little cost as the financing entity will pay for administrative and set-up costs. Third, it provides a single set of underwriting requirements for program approval and lending approval. Fourth, a single firm may well be able to do more volume and therefore provide lower rates.
- **Disadvantages.** First, a number of new financing approaches are being developed around the country. Exclusive rights to a single financing entity will restrict the availability of other financing that may provide better rates and/or serve building types and credits not served by the chosen entity. A number of firms are developing specialized financing products for community facilities, fuel cells, etc. Second, while the external costs for setting up a program can be covered by a private entity, many local governments have found that the largest costs are actually internal costs for managing the set up and operation. Additionally, the procurement process to hire a single financing entity adds significant complications and risk. Third, a number of local and national banks that hold commercial mortgages have indicated that they will provide their “lender consent” for a PACE financing only if their bank is also providing the PACE financing.

Open Market Approach. Under the “open market” approach, a local government – internally or by hiring an outside firm – creates and manages an administrative platform that allows multiple financing entities to finance projects in the community. The goal is to create a competitive marketplace for financing such that property owners can choose the best PACE financing for their particular project and building. While there may be a contract with an administrative firm, the local government allows any financing entity that meets the program specifications to

participate. The administrative costs can be paid up front by the local government or repaid over time through transaction fees.

- **Advantages.** This approach does not require a local government to “pick a winner” for PACE financing in their community and allows the market to evolve to serve the broadest range of building and project types. It reduces the hurdles involved with setting up a program.
- **Disadvantages.** Without a dedicated financing firm, there will likely be two sets of underwriting rules – one for the program and another set for project lenders. This adds complications to the program and may be confusing to property owners.

In summary, the open or closed market approaches offer a number of tradeoffs. Local governments should make decisions based on a full understanding of the opportunities and risks.