

Property **A**ssessed **C**lean **E**nergy

FHFA Regulator Concerns & Responses

February 2011

FHFA/Regulator July 6th Claims & Factual Responses

The Regulators' July 6th Announcements Stopped PACE and Ignored:

- State rights & legal precedent
- Detailed safety & soundness protections
- Specific written proposals from PACE stakeholders developed by the financial community
- Immateriality of PACE seniority (less than \$200 per home)
- Trial status: The nationwide PACE programs were designed as a 24 month trial to gather facts and data
- See link for [FHFA announcement](#) – or see appendix 8

The following Regulator Claims are excerpted from the FHFA Statement of July 6.

Regulator Claim #1: “PACE does not have ample safety and soundness protections for consumers and lenders”

PACE Response: As interest in PACE programs grew nationwide, considerable focus was placed on developing best practices and guidelines to ensure safety and soundness protections for program participants, including “consumers” and lenders. These efforts culminated in DOE Guidelines for PACE Pilots that were issued in May 2010. See protections initiated by state programs and codification during six months of analysis by White House Inter-Agency Task Force (click here for [White House Best Practice Consumer/Lender protections](#) or see appendix 3 & here for [DOE Guidelines for PACE Pilots issued May 2010](#) or see appendix 4). The DOE safety & soundness guidelines were developed in concert with HUD, NEC, Treasury, CEQ, OMB and the White House.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #2: “PACE will be bad for existing mortgage lenders because PACE is a senior lien”

PACE Response: Where is the risk? See New York Times journalist article titled “Analysis: Energy lien is little threat to loan giants” ([click here](#) for article or see appendix 5).

1) Properties Have Positive Equity: PACE benefits should only be extended to properties that have a comfortable margin of positive equity, protecting lenders and property owners in the event of a default.

2) Non-Acceleration of Assessments: FHFA voiced strong concerns about PACE’s senior lien status in the event of a default. This risk is mitigated by PACE program guidelines. For the small fraction of properties that might have inadequate equity and end up in foreclosure, PACE assessments (like all other benefit assessments) do not accelerate. Only the amount of unpaid assessments have a senior lien (typically 1 year of payments out of a total of 15 years). As with all other benefit assessments, the remaining PACE balance of future payments would be assumed by the new home purchaser. This modification reduced PACE senior lien exposure from the full balance of the retrofit (approximately \$15,000 on average) to only the delinquent back payment (approximately \$1,500). The \$1,500 of potential senior lien risk is further reduced by fact that mortgage defaults range from 5% to 10% so that the potential exposure would be \$75-\$150 per PACE home.

The FHFA argues that “any rational purchaser will treat his assumption of the continuing obligation to pay the PACE assessments — i.e., his assumption of the remaining PACE obligation — as a cost, and will reduce his cash bid accordingly,” but this logic is true ONLY if all existing property owners with PACE assessments have acted irrationally. In fact, PACE participants realize that energy efficiency and renewable projects make home more valuable.

3) PACE Improves Cash Flow: PACE guidelines stipulate that homes should target retrofit projects that result in energy cost savings net of the assessment payment. Improving owners’ cash flows make it easier for them to make mortgage payments, reducing the risk of default, and improving the value of lenders’ collateral. Note: Sonoma county, the largest PACE program is experiencing tax delinquencies on PACE homes that are 60% lower than non-PACE homes with no defaults*.

* Source: Sonoma County Tax Collector’s office. General delinquencies of 3.0%, PACE delinquencies of 1.2%.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #3: “Underwriting for PACE programs results in collateral-based lending rather than lending based upon ability-to-pay, the absence of Truth-in-Lending Act and other consumer protections, and uncertainty as to whether the home improvements actually produce meaningful reductions in energy consumption.”

PACE Response:

Ability-to-pay: The Regulators suggested using a debt-to-income test, and PACE advocates agreed to one that would not be overly burdensome to program costs. The Regulators never responded to this offer.

([See letter to FHFA with Debt to Income test proposal - see section 2 – III](#) or appendix 7).

Note that:

- Collateral-based financing – based on protective guidelines – poses no more risk than financing provided according to ability-to-pay, when using sufficiently conservative financing criteria.
- PACE financing is secured by property tax payments with extremely low default rates, historically below 2%. U.S. DOE guidelines require debt service reserve funds that protect investors from late payment or non-payment of PACE assessments; state laws such as California’s SB77 provide PACE programs establish adequate reserve funds.

Truth-in-Lending: The Regulators suggested additional Truth-in-Lending disclosures would strengthen PACE programs. PACE stakeholders agreed to additional disclosures. However, the Regulators never responded to this offer.

([See letter to FHFA - see section 2 - V](#) or appendix 7).

Home Improvement: PACE program guidelines require that property owners conduct upfront energy audits to identify cost-effective, energy-saving opportunities that can be measured and verified.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #4: “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.”

PACE Response: PACE programs rest on statutes that express a clear public purpose, created by state and local legislative bodies elected by voters. PACE relies on the method of “land-secured financing” that local governments have used for more than a century to levy special tax assessments through special taxing districts to fund sewers, sidewalks, seismic retrofitting, fire safety improvements, and many other projects that serve a public purpose. The voluntary or opt-in feature of PACE programs has ample precedent and makes sense for two obvious reasons: not all buildings would benefit from or require energy efficiency upgrades and there are no system wide economies of scale gained by assessing every property.

([See Paul Hastings legal opinion on PACE](#) – see appendix 1).

All special assessment districts rely on tax liens that are senior to the mortgage loan; PACE districts are no different.

- **Senior Assessments’ Long History in Underwriting/Mortgage Securitizations:** The 37,000 land-secured districts have senior assessments on more than 5 million properties* and are included in the standard mortgage underwriting process as well as being disclosed in RMBS and CMBS offering documents. PACE liens have the same status as regular property taxes or any other special assessment that servicers manage routinely.
- **At \$5 Per Home Immaterial Impact to Mortgage Investors:** Like other assessments, PACE senior liens in foreclosure are immaterial at \$200 or less per home (see calc in Claim #2). For mortgage investors, the numbers are even smaller as they depend upon the penetration of PACE. With a 3% PACE penetration rate, the senior lien exposure to mortgage bond investor would be $3\% * \$150$ or less than \$5 per home.**

* Based upon estimate of 150 properties per assessment program.

**Calculation details: Assume average \$15,000 PACE retrofit at 6% rate/15 year amortization = \$1,500 per year in payments. Assume in a foreclosure there are 2 years of delinquent payments ($\$1,500 * 2 = \$3,000$). If 5% of PACE homes go into foreclosure = $5\% * \$3,000 = \150 in back payment seniority per PACE home. If PACE has 3% penetration, the average mortgage bond pool would be exposed to $3\% * \$150 = \4.50 of PACE seniority per mortgage.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #5: “The size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.”

PACE Response: PACE assessments, which can range from \$2,500 to \$50,000 or more with terms up to 20 years, are similar in size and duration to many other “traditional” special assessments that can exceed \$50,000 per property for infrastructure improvements (such as undergrounding of utility services) with terms of up to 20 years. See Sonoma example on next page. Unlike many other large scale assessment, however, PACE assessments can actually improve a property owner’s cash flow.

PACE programs further public purposes defined by elected, state and local legislative bodies. Fannie Mae, Freddie Mac, and all federal regulators, past and present, have never been authorized to determine what constitutes a public benefit and have never endeavored to do so. Allowing the FHFA and OCC to do so now establishes a dangerous precedent. PACE programs promote a number of critically important public purposes or benefits including:

- Job creation
- Financial relief (cash savings) for property owners,
- Energy efficiency (avoiding the cost of building expensive new power plants),
- Reduced air pollution, and
- Energy independence.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Sonoma County Assessments: Long duration of from 10 to 40 years, average assessment range of \$4,000 to over \$100,000

Sonoma County - List of Property Tax/Special Assessments that are Analogous to PACE								
District Name & Issuing Authority	Improvements Constructed	First Year on Roll (1)	Last Year on Roll	Term of Original Bonds	Current Number of Parcels (2)	Average Assessment Amount (3)	Is debt senior to first mortgage	Voluntary (4)
Russian River County	Acquisition of existing private water system and improvements, including wells, pipes, etc.	2009	2048	39	27	\$9,936	Yes	Yes
Russian River County	Acquisition of existing private water system and improvements, including wells, pipes, etc.	2009	2048	39	21	\$26,000	Yes	Yes
Russian River County	Acquisition of existing private water system and improvements, including wells, pipes, etc.	2009	2048	39	6	\$56,286	Yes	Yes
County of Sonoma	Grade & pave roads, water, sewer, and storm drain installation	2006	2030	25	144	\$32,214	Yes	Yes
City of Healdsburg	Roadway upgrades to drainage, lighting and undergrounding utilities	2005	2014	20	387	\$3,773	Yes	Yes
Town of Windsor	Roadway upgrades to drainage, lighting and undergrounding utilities	2005	2025	20	21	\$233,321	Yes	Yes
Occidental Community	Construction of water well, booster pumping stations, and transmission mains	2005	2043	39	102	\$10,109	Yes	Yes
Petaluma	Roadway upgrades to drainage, lighting and undergrounding utilities	2004	2020	25	227	Com - \$33,697 Res - \$636	Yes	Yes
Petaluma	Roadway upgrades to sidewalks, drainage, lighting and undergrounding utilities	2004	2017	20	185	\$7,206	Yes	Yes
City of Cotati	Wetlands & salamander habitat mitigation	2003	2032	30	53	Com - \$755,884 Res - \$12,692	Yes	Yes
Petaluma	Construct new bridge, replace old bridge, underground utility improvements	2001	2019	25	8	\$399,250	Yes	Yes

Notes:

- (1) First year on roll for Refunded, Reassessed or Consolidated Bonds
- (2) Parcels on Tax Roll for most recent year
- (3) Comm=Commercial Res=Residential Bulk=Undivided parcels with multiple assessments
- (4) Based on majority vote of property owners

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #6: “First liens for such loans represent a key alteration of traditional mortgage lending practice. They present significant risk to lenders and secondary market entities, may alter valuations for mortgage-backed securities and are not essential for successful programs to spur energy conservation. While the first lien position offered in most PACE programs minimizes credit risk for investors funding the programs, it alters traditional lending priorities.”

PACE Response: All land secured financing districts – including PACE – place a senior tax/assessment lien on properties that receive a benefit from the financed improvement. Nationwide, more than 37,000 special assessment districts already exist and are a standard feature of the property appraisal, underwriting and disclosure process. With PACE, only assessments in arrears at the time of foreclosure – not the full amount – are paid before the mortgage, greatly limiting senior lien exposure risk.

Major protections for existing mortgage lenders:

1) Cash flow positive: PACE financed retrofits target cash flow positive savings in year 1. The Administration agreed to require that homeowners target retrofits where the savings in year 1 would exceed the annual assessment – such that the homeowner’s cash flow would improve. Note: Sonoma county, the largest PACE county in our nation, is experiencing tax delinquencies on PACE homes that is 60% below non-PACE homes – a testament to the potential of PACE to benefit all stakeholders, including existing mortgage lenders.

2) Non-acceleration: PACE’s senior lien status is limited to past due payments – FHFA expressed concern that in a foreclosure the PACE lien gets paid before the mortgage. This risk was cured by requiring that PACE programs only permit past due PACE payments when a home is in foreclosure (typically 1 year of payments out of a total of 15-20 years) to be paid senior to the existing mortgage. The remaining PACE balance and future payments are assumed by the new home purchaser. This modification reduced PACE senior lien estimated exposure to less than \$200 per home on a portfolio of homes.

3) Additional DOE Protections: Existing mortgage lenders are further protected by U.S. Department of Energy underwriting guidelines that limit PACE financing to 10% of a property’s assessed value; property owners with equity in their properties, a history of current property tax and mortgage payments; and, to property improvements with a positive return on investment.

FHFA/Regulator Infringement: Claims & Factual Response cont'd

Regulator Claim #7: “Efforts are just underway to develop underwriting and consumer protection standards as well as energy retrofit standards that are critical for homeowners and lenders to understand the risks and rewards of any energy retrofit lending program. However, first liens that disrupt a fragile housing finance market and long-standing lending priorities, the absence of robust underwriting standards to protect homeowners and the lack of energy retrofit standards to assist homeowners, appraisers, inspectors and lenders determine the value of retrofit products combine to raise safety and soundness concerns.”

PACE Response: On May 7, the U.S. DOE promulgated robust and prudent underwriting and consumer protection standards that lenders and local governments are using to limit risk and protect homeowners, including quality assurance and anti-fraud measures as well as strong underwriting standards that ensure PACE financing is only offered to homeowners capable of paying the special assessment. These protections were developed in concert with HUD, NEC, OMB, CEQ, and the White House.

- **No Disruption:** First liens – common to all types of special assessments – have not historically disrupted housing markets; there is no evidence to suggest that first liens related to PACE financing would do so.

In its statement, FHFA directed Fannie Mae and Freddie Mac to, among other things, “adjust loan-to-value ratios to reflect the maximum permissible PACE loan amount available to borrowers in PACE jurisdictions” and ensure “that loan covenants require approval/consent for any PACE loan.”

- **PACE Limits:** Existing U.S. DOE PACE guidelines limit PACE financing to 10% of a property’s assessed value, a conservative limit that protects both property owners and lenders.
- **Notification to Lenders:** U.S. DOE guidelines already state that mortgage holders should receive notice when residential property owners fund improvements using a PACE assessment.