

PACE Program Information
Response to Regulatory Agency Questions

There has been recent discussion among lenders, regulators, banks, cities, and others about the legal and financial basis for Property Assessed Clean Energy (PACE) programs. This memo is in response to those ongoing discussions and focuses on the issue of a local government's rights to pursue programs in the public interest. Three related issues form the basis for much this response.

First, PACE liens are tax liens like all other tax liens. A senior tax lien is a governmental power used to further a valid public purpose. PACE programs further a clear and compelling public purpose. In California, as in most other states, a priority lien is a power granted to government to allow it to further the public interest. This is not a new power nor one that is used infrequently. Unless the public purpose is deemed invalid¹ or the law unconstitutional, there is no legal basis for limiting government from exercising its taxing power. State laws establish senior tax and assessment lien for a reason: to enhance the ability of government to accomplish its public purposes.

Second, the placement of super senior special tax or assessment liens is an exceptionally common practice throughout the United States. The lending, underwriting, appraising, and insuring system in this country already accepts these types of liens as standard practice. PACE liens can be accommodated in exactly the same manner.

Third, PACE liens have a uniquely positive impact on the value of a property by increasing property values and reducing the costs of property ownership. PACE programs should be viewed as a net positive.

PACE programs pose significantly less risk to the property owner or lender than virtually any other tax or assessment district.

Below, we provide information regarding some of the questions and issues that have been raised. This information is provided to help guide and inform the discussion on these issues but should not be viewed as a legal determination of lenders, regulators or others.

1. Should Government Sponsored Lenders (GSEs) purchase loans communities with PACE programs?

Response: GSEs and lenders have been purchasing homes with assessment liens on them for decades. PACE program liens, if properly executed, should at a minimum

¹ California law requires a public purpose for a valid exercise of the taxing power, California courts have concluded that public purpose may be broadly defined by legislative bodies, and California courts defer to legislative bodies in their declaration of public purpose. *Daggett v. Colgan* (1891) 92 Cal.53; *Bank v. Bell* (1923) 62 Cal.App. 320.

be viewed similarly to all other assessment, special tax or other land secured liens rather than as a new product that changes the fundamental relationship to the lender.

- One of the largest title insurance companies in the country issued written formal guidance regarding “Clean Energy Assessment Districts.” After their internal review, they found that “as a title insurer, we would treat the special assessment in a clean energy assessment district the same way we treat real property taxes.”
- If GSE’s refuse to purchase loans in PACE communities, the GSEs will be in effect “redlining” communities that choose to exercise their taxing and assessment powers to pay for improvements that result in lower greenhouse gas emissions, improved local air quality, reduced stress on the local electricity grid and local job creation, all legitimate public benefits. In particular, such a refusal on the part of GSE’s could unfairly prejudice low- to moderate-income communities who elect to use their assessment authority for the public purpose of improving environmental and economic conditions for community members.

2. Should lenders lower available credit by the amount of the potential PACE lien?

Response: The GSE’s should not be concerned about purchasing loans in PACE communities, given:

- PACE programs increase a home’s value. A study in Appraisal Journal found that for every utility-bill dollar saved annually because of an improvement, you gain \$20 in property value. So reducing your utility bill by \$1,000 will return \$20,000 in home value.
- PACE liens generally provide a net positive return on the investment from the offsetting energy savings.
- PACE loans provide protection against rising energy prices. Rising energy prices will impact a borrower’s ability to repay their mortgage loan and the presence of energy efficiency or on-site generation improvements provide considerable protection for homeowners in a rising energy price environment. In a lower energy price environment, although the value of savings generated may be reduced, homeowners overall energy cost burden is lower. Thus PACE loans provide a hedge against energy price fluctuations.
- PACE lien seniority is immaterial: In a portfolio of homes, each with a \$250,000 mortgage, the PACE lien seniority in foreclosure probably amounts to less than \$100 per home (less than 1/20th of 1% of the mortgage value).
 - Explanation: In a foreclosure, most state laws provide that only the back tax lien payment gets paid off before the mortgage. The rest of the balance gets reinstated post bankruptcy.
 - Assumptions:
 - \$300,000 home, \$250,000 mortgage and a \$20,000 20 year PACE loan at 6% interest rate.
 - Annual PACE lien amortization payment is approximately \$1,700.

- Foreclosure situation: In the above situation, if the house is foreclosed on and there is 1 year of unpaid PACE liens then only \$1,700, the past due tax lien payment, gets paid ahead of the mortgage (less than 1% of the value of the home). The remaining balance gets reinstated as a long term lien after the foreclosure.
 - Fewer than 5% of homes are foreclosed on: Historically, less than 5% of all homes have 2 or more delinquent mortgage payments (source: American Mortgage Bankers Association). That means that a "portfolio" of Fannie/Freddie mortgages that have PACE liens will be impacted by 5% x \$1,700 or \$85, on average, per home and that assumes NO VALUE from the PACE dollars that were spent. The PACE dollars invested clearly add value such that there should be no credit impairment but instead credit enhancement.
 - Note: In the worst housing crisis in decades, homes with 2 or more delinquent payments have peaked at about 10% such that the above numbers in a worst case scenario increase to only \$170 per home or less than 1/10th of 1% of the mortgage value.
- PACE liens generally represent less than 10% of the overall value of the home. These limits can be required with Best Practice safeguards.

3. Should securitization of mortgage loans be made more difficult with non-uniform state/municipal programs?

Response: The PACE Best Practices are being developed in conjunction with advice from experts in the securitization field to ensure that mortgages with PACE liens can be part of securitization programs. This will also help ensure that mortgages on properties with PACE liens are not more expensive but potentially LESS expensive because of the credit enhancing nature of the energy savings.

4. Should lenders enforce provisions under the Uniform Security Instruments? (Fannie Mae/Freddie Mac mortgage forms) which prohibit liens that have priority over first lien mortgages.

Response: To our knowledge, a government exercising its legal powers to add or enforce tax liens has never prompted a mortgage lender to enforce contractual provisions regarding lien seniority. Such liens are standard practice.

5. Will State laws trigger event of default?

Response: After discussions with leading municipal law firms, there was unanimity of opinion that there is no known law in California in which a legally placed special tax or assessment lien, such as PACE, triggers a default. In California, special tax and assessment liens are senior as a matter of statute.³

³ In general with respect to the lien of taxes and assessments, Revenue & Taxation Code declares: "Every tax declared in this chapter to be a lien on real property, and every public improvement assessment declared by law to be a lien on real property, have priority over all other liens on the property, regardless of the time of their creation. Any tax or assessment described in the preceding

6. Should Mortgage Insurance/Title Insurance be more difficult to obtain?

Response: Mortgage insurance is obtainable on land secured districts, business improvement districts and the newly enacted PACE districts. One of the largest title insurance companies in the country issued written formal guidance regarding “Clean Energy Assessment Districts.” After their internal review, they found that “as a title insurer, we would treat the special assessment in a clean energy assessment district the same way we treat real property taxes.”

7. Will lenders and mortgage investors institute legal challenges?

Response: A legal challenge to PACE programs is speculative. However, PACE programs benefit from over a century of municipal finance experience and law. The legal challenge to a PACE program would appear to require the courts to (1) invalidate state laws, (2) strip local governments of a taxation power they’ve had for over a century, and/or (3) find that reducing energy use and carbon emissions is not a valid public purpose, all of which seem unlikely based on relevant judicial precedent.⁴

sentence shall be given priority over matters including, but not limited to, any recognizance, deed, judgment, debt, obligation, or responsibility with respect to which the subject real property may become charged or liable.”

With respect to special assessments, Government Code Section 53930 et seq. was adopted by the Legislature to make uniform the priority of special assessment liens and is controlling over other applicable general and special laws. In Section 53931, the Legislature established that special assessments constitute a lien on real property: “All special assessments in which the amount thereof is apportioned among the several parcels of land assessed shall constitute a lien in said respective amounts upon the several parcels assessed, which lien shall continue for the period of time provided in the Civil Code for enforcing same.”

In Section 53935, the Legislature established the priority of the lien: “53935. The lien of said assessments shall be coequal to and independent of the lien for general taxes, and, except as provided in Section 53936, not subject to extinguishment by the sale of the property on account of the nonpayment of any taxes, and prior and superior to all liens, claims and encumbrances except (a) the lien for general taxes or ad valorem assessments in the nature of and collected as taxes levied by the state or any county, city, special district or other local agency; (b) the lien of any special assessment or assessments the lien date of which is prior in time to the lien date of the assessment for which the deed is issued; (c) easements constituting servitudes upon or burdens to said lands; (d) water rights, the record title to which is held separately from the title to said lands; (e) restrictions of record.”

With respect to special taxes levied under the Mello-Roos Community Facilities Act of 1982, Government Code Section 53340(e) provides in relevant part: “The special tax shall be collected in the same manner as ordinary ad valorem property taxes are collected and shall be subject to the same penalties and the same procedure, sale, and lien priority in case of delinquency as is provided for ad valorem taxes ...”

⁴ Provident Institution for Savings in Jersey City v. Mayor and Alderman of Jersey City (1885) 113 U.S. 506 (“Even if the water rents in question cannot be regarded as taxes, nor as special assessments for benefits arising from a public improvement, it is still by no means clear that the giving to them a priority of lien over all other incumbrances upon the property served with the water would be repugnant to the constitution of the United States. The law which gives to the last maritime

8. Will higher mortgage rates be charged in PACE markets?

Response: Again, this assumes that from a lender point of view, PACE programs differ in a meaningful way from other assessment or special tax districts. From lender point of view, there is no substantive difference between a PACE lien and an underground utility district lien, for example. There is no evidence that properties in existing built environment tax districts have experienced higher mortgage rates.

9. Will the value of the energy improvements be reflected in appraised value of property?

Response: While it is possible that the energy improvement may not be fully recognized in every case, there is substantial evidence to suggest that appraised and market values increase when an energy improvement is made. For example, the Appraisal Journal found that home values were increased by \$10-\$25 for every \$1 reduction in annual energy bills.⁵

10. Will borrowers have reduced opportunity to refinance?

Response: Once again, there is no meaningful or tangible difference between a PACE lien and an increased property tax. In that circumstance, the lien is a standard property tax lien that is viewed as an additional cost burden during the refinance underwriting process.

11. Will lenders incur credit losses?

Response: As described in detail above, this should not be the case for a variety of reasons. Most important, in PACE lien cases with a savings to assessment ratio > 1 (annual energy cost savings exceed the annual assessment amount), this improves the borrower's ability to pay which will help to decrease borrower defaults and therefore reduce lender losses. In cases where the net present value of the improvements is positive, then the lender has increased collateral once the PACE improvement is in place than prior to the PACE improvement and should therefore improve net proceeds recovered in foreclosure. In such cases, lenders actually enjoy in effect an immediate improvement (i.e., reduction) in LTV ratio once the PACE improvement is installed.

12. Should mortgages be devalued?

Response: Based upon the earlier stated facts, the value of a GSE/lender mortgage portfolio with PACE liens should go up due to the improvement in the borrower's cash flow and/or the positive net present value of the projects. In those cases where a foreclosure were to happen, it will most likely not be due to a small PACE lien payment but instead due to the borrower's inability to pay the mortgage.

liens priority over earlier liens in point of time, is based on principles of acknowledged justice. That which is given for the preservation or betterment of the common pledge is in natural equity fairly entitled to the first rank in the tableau of claims."); German Savings & Loan Society v. Ramish (1902) 138 Cal 120 ("The power to levy a tax for general purposes, which shall be a lien superior to all other liens, prior or otherwise, is not doubted, and it is not because it is called a tax, but because of its object and the necessity for raising revenue in order to execute the functions of government.")

⁵ Nevin and Watson, Appraisal Journal, 1998