

PACE Programs: Historical Precedent, Seniority and Benefits to Existing Lenders

Policymakers have looked at many options to help property owners pay for energy improvements in a manner that would eliminate burdensome upfront costs and allow the financing agreement to transfer with the property. One program that is rapidly gaining interest is the so-called “Property Assessed Clean Energy” (PACE) program. Both Congress and The White House have shown tremendous support for the PACE model.^{1, 2, 3} This memo is intended to describe how PACE programs benefit existing mortgage lenders and to address the validity of senior liens associated with PACE finance. The major points are as follows:

1. PACE is a form of land secured financing districts which are included in state law and have a long established and accepted history.
2. The seniority of PACE liens is supported by their status as “assessments” and the right of state governments to advance as a valid public purpose.
3. If PACE liens are structured as subordinate, then PACE programs would be unduly burdensome to administer and potentially prohibitively costly. [See Barclays Memo](#)
4. PACE programs pose significantly less risk to lenders and property owners than virtually any other tax or assessment district.
5. The value of properties with PACE liens should increase due to the reduction in the properties’ energy costs and the positive net present value of the projects.
6. The Federal Policy Framework regarding PACE outlines numerous underwriting standards to further reduce the risk of default.
7. **PACE** lien seniority in foreclosure is immaterial: On a portfolio of homes, each with a \$250,000 mortgage, the PACE lien seniority in a foreclosure situation probably amounts to less than \$100 per home and is more than offset by the increased property value.

Land Secured Financing Districts

For the most part, PACE programs are simply additions to existing state laws that already authorize the creation of “land secured” financing districts to pay for improvements in the public interest, whether publicly or privately owned.

Land secured financing districts – which are creatures of state law and are variously referred to as assessment districts, public improvement districts and community facilities districts, among other terms – are a building block of municipal finance and have been utilized for more than a century. They are used to finance projects which serve a public purpose, including street paving, parks, open space, water and sewer systems and street lighting, among others.⁴

All land secured financing districts operate by placing a senior tax/assessment lien on properties which will receive a benefit from the financed improvement. The lien secures a tax/assessment payment that is levied on properties through the property tax bill. Tens of thousands of these districts already exist in this country and are a standard part of the property appraisal, underwriting and disclosure processes.

Validity of the Senior Lien

In most states, a government can place a tax or assessment lien to advance a valid governmental purpose. This is not a new power, nor one that is used infrequently. Unless the purpose is deemed invalid or the law unconstitutional, there is no justifiable reason for government to be prohibited from exercising this power.

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Not only is the right of municipalities to place a senior lien to support a public purpose supported by decades of precedent, it is critical to the success of PACE financing. Given Standard and Poor's published criteria for bond ratings backed by special tax assessments, it is likely that a subordinate PACE Assessment Bond will be rated below investment grade yielding unmanageably high interest rates.⁵ Furthermore, there is no practical or cost effective manner for County tax collectors, administrators, fiscal agents, or bond trustees to manage a subordinate PACE lien and creating a new set of procedures would be prohibitively expensive.

Market Ramifications

The market effects of PACE districts are no greater than those of traditional assessment districts, which have been implemented across the U.S. for decades. In fact, PACE programs pose significantly less risk to lenders and property owners than virtually any other tax or assessment district.

1. PACE lien seniority in foreclosure is immaterial and is more than offset by the increased property value: On a portfolio of homes, each with \$250,000 mortgages, the PACE lien seniority in a foreclosure situation probably amounts to well under \$100 per home. Alternatively, on a \$10 million commercial building, PACE lien seniority in a foreclosure probably amounts to less than .5% of the property's value.

- **Note:** In a foreclosure, most state laws provide that only the back tax lien payment is satisfied before the mortgage note. The rest of the balance is reinstated post bankruptcy.
- **Residential example:** Assume you have a \$300,000 home, \$250,000 mortgage and \$20,000 (6% interest rate) 20 year PACE loan that is paid off \$1,700 per year for 20 years. If the house is foreclosed on with 1 year of PACE payments in arrears, then the 1 year of back payment - or \$1,700 – is paid ahead of the mortgage, not the full \$20,000. So in this example, the mortgage has \$1,700 paid ahead of it (less than 1% of the value of the mortgage). Far fewer than 10% of homes will result in foreclosure (10% is where the subprime crisis peaked). For conservatism, assume 10% of all PACE homes in the above scenario result in foreclosure. This suggests that with a "portfolio" of Fannie/Freddie mortgages that have PACE liens, the impact is 10% x \$1,700 or \$170 (yes, one hundred and seventy dollars per home on average). Realistically, probably less than 5% of homes would result in foreclosure, which results in an average \$85 of seniority in foreclosure on the hypothetical portfolio of Fannie/Freddie mortgages.
- **Commercial example:** Assume you have a commercial building worth \$10 million and that it has a mortgage of \$8 million and does a \$500,000 PACE retrofit (5% of the value of the building as commercial retrofits tend to be much smaller percentages of overall building value – 5% is conservative). Assume the PACE project is financed with a 6%, 20 year loan such that there are annual payments of about \$43,000. If the building is foreclosed on after a year and there is a PACE payment in arrears then this amount, \$43,000, is paid ahead of the mortgage. This represents about .5% of the value of the mortgage.
- **Increased property value:** Note that the foregoing calculations assume no increased value to the property resulting from the PACE dollars that were spent. The PACE dollars spent add value and in the above examples the retrofit improvement dollars spent

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exceed the PACE seniority payments by more than one thousand percent, or 10 fold. So not only are the PACE seniority payments immaterial but they are more than offset by the much larger monies spent on improvements.

- **White House framework:** The Federal Policy Framework also supports the establishment of program “Assessment Reserve Funds” which will protect the bondholder from late payment of the assessment. Appropriately sized reserve funds will provide an additional layer of protection to existing mortgage holders.

2. GSEs and lenders have been purchasing homes which hold assessment liens for decades: PACE program liens, if properly executed, could at a minimum 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 concluded 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.”
- Properties with PACE assessments represent less risk to lenders since participation is voluntary and financed improvements generate savings and increase property value.

3. PACE increases the value of properties: Property value increases due to the reduction in the properties’ energy costs and the positive net present value of the projects.

- PACE programs increase a home’s value. A study in *Appraisal Journal* found that for every utility-bill dollar saved annually, due to an improvement, a property owner will gain \$20 in property value. So reducing a utility bill by \$1,000 will return \$20,000 in home value.^{6,7}
- The White House Policy Framework for PACE Financing Programs (Federal Policy Framework) establishes positive net present value criterion.⁷ By definition, improvements with a positive net present value will increase the underlying value of the home prior to the improvements, meaning that the underlying lender should receive more in foreclosure than would be the case absent the improvements.

4. PACE programs will decrease the risk of default: Improvements financed by PACE should have a Savings vs. Investment ratio > one. The fact that energy savings will in most cases exceed the financed cost of the improvements will improve the borrower’s ability to pay, helping to decrease borrower defaults and therefore reduce lender losses.

- The length of the assessment may not exceed the useful life of financed improvements.
- The maximum ratio of the lien to the property value should be limited, generally not exceeding 10% of the property’s market value.
- All owners of the property must approve the assessment, and the title should be free of easements or subordination agreements that conflict with the assessment.
- In order to be eligible, properties must be current on property taxes, have no outstanding liens, have no notices of default for a specified period, and be current on all mortgage debt.
- The property owner cannot have negative equity in the home.

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Sources:

1. U.S. DOE, Press Release, *Vice President Biden Unveils Report Focused on Expanding Green Jobs And Energy Savings For Middle Class Families*, Oct. 19, 2009, <http://www.energy.gov/news2009/8148.htm> (last visited Dec. 22, 2009); PACENOW. "PACE RETROFIT FINANCE WILL BE KEY COMPONENT OF OUR NATION'S "RECOVERY THROUGH RETROFIT" Program." Online video clip, <http://www.youtube.com/watch?v=2HpwQff2tIA> (last visited Feb. 4, 2010).
2. See Letter from U.S. Senate et. al., to President Barack Obama available at <http://pacenow.org/documents/Letter%20to%20President%20Obama%20re%20PACE,%2011.10.09.pdf> (Nov. 10, 2009)
3. See N.Y. Congressman Steve Israel, *Roll Call: PACE Bonds Promote Efficiency*, Oct. 19, 2009, http://www.rollcall.com/features/Policy-Briefing_Energy-2009/energy_environment/39556-1.html (last visited Dec. 22, 2009).
4. See, e.g., *Daggett v. Colgan*, 92 Cal. 53 (1891); *Bank v. Bell*, 62 Cal. App. 320 (1932).
5. See Letter from Barclays Capital, to PACE Working Group, *PACE: Property Assessed Clean Energy Financing – Capital Markets Financing Issues Paper*, (May 15, 2009), available at <http://pacenow.org/documents/5a.%20Barclays%20Memo.pdf> (last visited Feb. 4, 2010).
6. See Nevin, Rick and Gregory Watson, *Evidence of Rational Market Valuations for Home Energy Efficiency*, *Appraisal Journal* (1998), [http://pacenow.org/documents/EnergyEfficiency\(2\)_appraisal%20J.PDF](http://pacenow.org/documents/EnergyEfficiency(2)_appraisal%20J.PDF) (last visited Feb. 4, 2010).
7. See Kenneth R. Harney, *Investor Report: Energy Efficiency*, *Realty Times* (July 10, 2009), http://realtytimes.com/rtpages/20090710_investorreport.htm (last visited Dec. 22, 2009).