

Response to FHFA/OCC July 6 Statements that Block PACE

The Regulator criticisms of PACE consisted of the senior lien status of PACE and a number of old concerns that were solved by a White House led inter-agency task force which included HUD, NEC, OMB, CEQ, and DOE (and which FHFA provided feedback to). The Regulators also ignored specific proposals made during 2010 to FHFA's general counsel/OCC officials from senior administration officials and PACE stakeholders. Put simply, the Regulators ignored the immateriality of the risk given the safeguards that were developed (click here for White House PACE Best Practice requirements and here for DOE PACE Pilot Guidelines) and the fact that this was designed specifically as a 24 month trial period. As Governor Schwarzenegger pointed out, this action by the Regulators also challenges the 100+ year history of tax assessments being managed by local government (link to Governor Schwarzenegger letter).

Item 1: Regulator Claims and PACE Responses

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

PACE Response:

1. White House Inter-Agency Task Force develops consumer and lender protections (click here for White House Best Practice Consumer/Lender protections and here for DOE Guidelines for PACE Pilots issued May 2010). The DOE guidelines were developed in concert with HUD, NEC, CEQ, OMB and the White House.

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).

1. **Less than \$200 of Seniority per PACE Home:** One of the biggest criticisms from FHFA was 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 years) to be paid senior to the existing mortgage. The remaining PACE balance and 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. .

2. **PACE financed retrofits would target cash flow positive/reduce mortgage delinquencies** – As part of our nation's PACE guidelines, 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 and the risk of mortgage default would go down. 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.

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 that using a debt-to-income test – to ensure that PACE assessments to strengthen PACE programs. The Administration & PACE stakeholders agreed to a debt-to-income test that would not overly burden the cost of PACE programs. However, the Regulators never responded. (See letter to FHFA with Debt to Income test proposal - see section 2 - III).

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. The Administration & PACE stakeholders agreed to additional disclosures. However, the Regulators never responded to this offer. (See letter to FHFA - see section 2 - V).

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

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 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. (See Paul Hastings legal opinion on PACE).

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

PACE liens have the same status as regular property taxes or any other special assessment and do not interfere with, or impair, mortgage lenders’ contractual rights to repayment.

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 more “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.

By reducing the property owner's energy bill, PACE is the *only* type of special assessment that actually improves cash flow to the property owner by lowering operating expenses. In addition to reducing financial risk for the property owner, PACE financing delivers community benefits of cleaner air, local economic development and cost savings. By reducing energy use and generating renewable energy, PACE cuts greenhouse gas emissions and other harmful pollutants from the burning of fossil fuels and reduces a community's reliance on imported energy sources. These community benefits are no less worthwhile than realized by other special assessments.

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.

3 major protections for existing mortgage lenders:

1. 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. 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.

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.

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”.

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.

U.S. DOE guidelines already state that mortgage holders should receive notice when residential property owners fund improvements using a PACE assessment.