PACENOW

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PACE finance has the potential to dramatically accelerate the energy retrofit of our nation's building stock, while benefiting homeowners and existing lenders, creates large job growth and all with no credit or general obligation risk to municipalities (see PACE Advantages).

PACE enabling legislation has passed in nearly 20 states over the past year, the advantages are well accepted and PACE has broad bipartisan support (see PACE Endorser List for supporters). Early in the development of PACE in 2009, certain concerns were raised by the housing and banking communities. These concerns were resolved late last year with the White House's Policy Framework that was announced by Vice President Biden at his Recovery Through Retrofit hearing (this framework was developed as a collaboration between HUD, the Dept of Energy, the FHFA, and the National Economic Council - see Biden YouTube clip and White House Report). The note below outlines the concerns that were raised and how they have been solved.

The Institutionalization of PACE Finance, Frequently Raised Concerns & White House Solutions

I. **Early PACE.** PACE has only been around for 18 months but has already evolved from its early stage to include much tighter consumer and lender protections. The early PACE programs that were launched in 2008 and 09 – Berkeley, Boulder, Palm Desert, Sonoma – were extremely small and all in fairly wealthy communities. As pilots, we learned that the PACE concept could work and potentially be very large through the inclusion of many different forms of property, including commercial, industrial, hospitality and multi-family. We also learned that it could be improved through institutionalization of Best Practices as a mean to ensure it was good for all stakeholders. PACENOW was founded specifically to develop best practice standards for PACE, to accelerate adoption, and to ensure that it represented excellent public policy for the various stakeholders.

II. **The Birth of PACE Institutional: White House PACE Framework.** As PACE was gaining traction, the White House led an inter-agency working group to develop the PACE Policy Framework in the summer and fall of 2009. The goal of the Framework was to establish clear guidelines to protect consumers and minimize risk for lenders and borrowers. While not mandatory, these measures are now being used by municipalities launching **the new generation of PACE** programs, (PACE Institutional or New PACE). At the bottom of this memo attached you will find the 11 major Best Practice items in the White House framework (3 homeowner and 8 lender protections).

Our nation's first major PACE initiative is in San Francisco and has incorporated the White House Framework (See GreenFinanceSF Program). Smaller municipalities, like Montgomery County, MD are embracing the Best Practice Framework as well (See Montgomery County).

The key components of the White House Policy are being incorporated in the **NEW PACE** programs that are being launched throughout California, as well as in New Mexico, Louisiana, and Maryland. See attachment 1 - GreenFinanceSF Program Terms. Please note that the White House PACE Framework is specifically targeted at PACE single family residential. PACE programs benefit many different forms of property, including commercial, industrial, hospitality and multi-family.

III. Isn't PACE lien seniority material to existing lenders who become subordinated?

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 less than $100 per home.

Note: In a foreclosure, most state laws provide that only the back tax lien payment is satisfied before the mortgage note and the rest of the balance is reinstituted post bankruptcy. The White House framework recommends this "no due upon sale" treatment as a best practice.

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.

IV. How is PACE Financing different from traditional home equity lines of credit?

- PACE can only be used to finance specific energy efficiency, renewable energy and water efficiency improvements as opposed to home equity lines that frequently reduce the equity value of a house (e.g. home equity lines are used to pay for college education, medical bills and so on). Unlike home equity lines, all PACE improvements must be capital expenditures and they must have a public benefit. These factors make a PACE project very different from using a home equity line that potentially depletes home value. See GreenFinanceSF Eligible Projects List which shows you a list of eligible PACE projects from the **NEW PACE** programs.

- Secondly with PACE, you are not financing people, you are financing the property. That's why the underwriting criteria are based on property value and the history of timely property tax payments and the property's current market value and debt load.

- Finally, energy efficiency and renewable energy investments under best practices are designed to "pay for themselves," which is to say that the homeowner's utility bill goes down by more than their property tax bill goes up. In this way, not only does it increase the value of a home in the long run, but it allows the homeowner to lower their annual out-of-pocket costs from day one. Most new PACE programs are requiring that energy efficiency improvements achieve at least a 20% reduction in energy use – not just one small measure.

V. What protections are there to ensure that contractors don't take advantage of homeowners?

1. Financings are for high value investments (White House Homeowner Protection item 2)
2. Energy audits are required prior to most installations. The audits allow homeowners to see the cost savings for their investment.

3. Contractors must not only be licensed and bonded, but have an energy efficiency certification (such as Building Performance Institute) and have agreed to specific requirements for the program.
4. Random audits and inspections of completed work are performed on all projects (White House Homeowner Protection item 3)
5. Ability to get contractors to fix work and to disqualify contractors from programs (White House Homeowner Protection item 3)

VI. How can PACE be underwritten by municipalities?

First, it is important to note that local governments are uniquely positioned to run good programs because of their clear mandate to protect and enhance communities. In many ways, having a local government heading up programs like this is one of the best ways to protect property owners – they have no other obligation but to do just that.

Second, local governments have had responsibility for underwriting property and energy related programs like these for decades. For example:

- Many cities provide first time homebuyer assistance. For example, look at the City of Austin. http://www.ci.austin.tx.us/ahfc/firsttime.htm
- Cities have provided various types of energy loan programs for years. For example, look at the City of Tallahassee, FL. http://www.talgov.com/you/energy/loans.cfm.

While some handle this responsibility in-house, many others simply contract for those services. Under PACE, municipalities can do proper underwriting either in-house or by bringing in an experienced contractor to assist.

The PACE programs getting started now are generally bringing in an experienced underwriter.

VII. Since PACE does not look at incomes (debt to income ratios) doesn't this mean PACE can put people further under water?

The goal of looking at debt to income ratios is to stop people from incurring debt they can't afford. PACE accomplishes the same goal through other means.

1. PACE looks at value of the property to ensure there is equity value (see item 6 from White House Lender Protection Guidelines).
2. PACE generally requires savings to investment ratios of greater than 1 so that the cash flow of the borrower increases and therefore the risk of default decreases. This taken together with no "negative equity value" in item 1 assures that PACE is done in situations where there is equity value and that PACE increases the equity value further.
3. Other credit safeguards:
   PACE is limited to 10% of the value of the home (White House Lender Protection - item 3)
   Clear title must be proven (White House Lender Protection - item 4)
   No current default on taxes, liens, mortgages, etc. (White House Lender Protection - item 5)
   Length of time – maturity of debt matches life of improvements (White House Lender Protection - item 2).

11 Homeowner and Lender Protections in the White House PACE Policy Framework

I. Homeowner Protection

Effective consumer protection is a crucial first line of defense against defaults that would harm both homeowners and lenders. PACE programs should help assure that energy retrofits are designed to pay for themselves within a reasonable period and that homeowners are protected against fraud or substandard work.

1. *Savings to Investment Ratio.* As has long been the case for DOE's single-family weatherization program, the "savings to investment ratio" for PACE program assessments should be greater than one. This "pay for itself" principle means that the expected average monthly utility savings to homeowners should be greater than the expected monthly increase in tax assessments due to the PACE energy efficiency or renewable energy improvements. Improvements should be made where there is a positive net present value, so that expected total utility bill savings are estimated to be greater than expected total costs (principal plus interest). In some instances, tax credits or other subsidies are available to support investments. If so, then the present value of the expected savings to consumers should be greater than the present value of the increase in assessments once those subsidies are included.

2. *Financing Should be for High-Value Investments.* Financing should be limited to investments that have a high return in terms of energy efficiency gains. In some cases, investments can be limited to a set of projects that have well-documented efficiency gains for most houses in a climate zone, such as sealing ducts or installing insulation. In other cases, investments will be based on the results of an authorized energy audit that identifies the energy efficiency gains for a particular house for a particular retrofit. Ensuring that loans are made for these high-value investments will protect homebuyers and mortgage lenders, and maximize the impact of PACE on improving energy efficiency.

3. *Assuring that the Retrofit is Constructed as Intended.* First, the scope of the retrofit should be determined by a list of presumptively-efficient projects or based on an energy audit, conducted by a qualified auditor or inspector. Second, validly licensed contractors or installers should do the actual home improvements. Third, there should be an after-the-fact quality assurance program. Qualified raters should do reviews upon completion, for the portion of houses needed to assure program quality, to assure that correct work was performed and is up to standards. If the property owner or local government administering the contract is not satisfied with a retrofit or if the follow-up rating shows that the work was not completed in a commercially reasonable manner, the contractor should be required to fix the work. If that does not solve the problem, then just as with any construction project, payment to the contractor can be withheld until such a time as the work is done satisfactorily or the homeowner can seek other redress. In circumstances where a project is not completed to standards, the contractor should be disqualified from further work under the PACE program - a strong incentive to complete work correctly.

This approach provides important incentives and safeguards for all of the relevant parties. For homeowners, the "pay for itself" principle assures that the expected savings exceed the investment, and the protections afforded for proper projects and work address concerns about inappropriate or substandard work. For mortgage and other lenders, these safeguards reduce the risk that overly expensive, substandard, or uneconomic projects will be undertaken, protecting the value of the house that serves as collateral for the loan.

Furthermore, PACE programs must comply with applicable federal and state consumer laws and include adequate disclosures to and training for homeowners participating in the program. For instance, local governments implementing PACE programs must disclose the risks to participating property owners, including risks related to the default and foreclosure that could result from failure to pay assessments. Along with training and certification standards to be established by DOE and the Department of Housing and Urban Development (HUD), effective anti-fraud measures should be implemented. To avoid "copy cat" programs that offer PACE-like programs without these protections, local, state and federal consumer protection enforcement agencies should target mortgage fraud scams and "copy cat" programs.

II. Lender and Borrower Protection

Beginning immediately, this Policy Framework supports additional measures to further limit risk to mortgage lenders:

1. *Assessment Reserve Fund.* A reserve fund should be established at the local-government level, to protect the energy investor against late payment or non-payment of the assessment. This reserve fund means that the value of mortgage lenders' collateral should not be reduced by any failure by the homeowner to pay the PACE assessment.

2. *Length of Time.* The length of time for a homeowner to repay the PACE assessments should not exceed the life expectancy of the energy efficient improvements.

3. *Size of Financing Relative to the House Value.* As a general matter, PACE assessments should not exceed a certain percentage of appraised value of the home, generally 10%.

4. *Clear title.* Applicants must prove they are the legal owners of a property, unanimous approval of property-holders is required, and the title should be clear of easements or subordination agreements that conflict with the assessment.

5. *PACE Financing only where no current default.* Participation in the program should not be allowed unless: (i) property taxes are current; (ii) no outstanding and unsatisfied tax liens are on the property; (iii) there are no notices of default or other evidence of property-based debt delinquency for the lesser of the last three years of the property owner's period of ownership; and (iv) the property is current on all mortgage debt.

6. *No Negative Equity Financing.* PACE loans to borrowers who are "underwater" - whose mortgage and other debt on the property is greater than the current value of the house - raise particular risks because such loans are especially likely to default with less than full payment to private lien holders. PACE programs should require a current estimate of appraised value, and outstanding property-based debt cannot be less than the value of the property.

7. *Vulnerable Areas.* Local governments should be cautious in using the PACE model in areas experiencing large home price declines, where large numbers of "underwater" loans may exist. PACE programs in such areas should proceed only after careful attention to local real estate conditions and programmatic safeguards to avoid contributing to additional borrower defaults.

8. *Escrow.* To reduce the risk of non-payment of property assessments, homeowners should escrow payments for PACE programs in the common situations where they already escrow other property tax assessments.