STATE CAPITOL
P.O. BOX 942849
SACRAMENTO, CA 94249-0091
(916) 319-3081
FAX (916) 319-3181

Assembly
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"Keeping Up With PACE: A Joint Oversight Hearing on Residential Property Assessed Clean Energy Programs"

Assembly Committee on Banking and Finance

Thursday, June 9, 2016
10:00 a.m. – 1:00 p.m.
Room 437

Introduction:

In 2008, under AB 811 (Levine & Beall), the Legislature found the following:

> *"Energy and water conservation efforts, including the promotion of energy efficiency improvements to residential, commercial, industrial, agricultural, or other real property are necessary to address the issue of global climate change.*
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> *The upfront cost of making residential, commercial, industrial, agricultural, or other real property more energy and water efficient prevents many property owners from making those improvements. To make those improvements more affordable and to promote the installation of those improvements, it is necessary to authorize an alternative procedure for authorizing assessments to finance the cost of energy and water efficiency improvements.*
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> *The Legislature declares that a public purpose will be served by a voluntary contractual assessment program that provides the legislative body of any public agency with the authority to finance the installation of distributed generation renewable energy sources and energy or water efficiency improvements that are permanently fixed to residential, commercial, industrial, agricultural, or other real property"*

Almost 10 years later, the intent of the Property Assessed Clean (PACE) Program remains which is, "energy and water conservations efforts...are necessary to address the issue of global climate change." California enacted the first statewide PACE Program in 2008 to combat climate change. Since 2008, the PACE program has spread across the state through cities and counties adopting resolutions and at least 31 other states have created their own PACE program with variations.

When created, it was presumed that public agencies would run the PACE program themselves; instead the majority of cities or counties have contracted out the services to new unregulated private entities to administer the PACE program. Only one program runs their own PACE program internally: Placer County.

Additionally, when established, the Legislature did not foresee the attention the PACE program would receive from the Federal Housing Finance Agency (FHFA) and the Federal Housing Administration (FHA) or the impact the PACE program could have on California's housing market.

The PACE program continues to gain traction among California homeowners who want to improve their carbon footprint and need a financing alternative to allow them the opportunity. With every newly created program, unintended hurdles appear (discussed below). During this joint oversight hearing we will examine these hurdles and determine how best to move forward with the goal to improve and strengthen the PACE program.

Background:

PACE is an innovative financing tool that residential or commercial property owners can use to pay for renewable energy upgrades, energy, or water efficiency, or electric vehicle charging stations for their homes or buildings. Local agencies created PACE assessment districts in their jurisdictions via a resolution of their legislative body, allowing the local agency to issue bonds to finance the up-front costs of improvements. In turn, property owners enter into a voluntary contractual assessment agreement with the local agency to re-pay the bonds via an assessment on their property tax bill. The assessment remains with the property even if it is sold or transferred, and the improvements must be permanently fixed to the property.

PACE programs typically are more attractive to borrowers and lenders because they can offer a longer pay-back period (up to 20 years) with smaller payments than other types of loans, and they are securitized by the property assessment rather than the borrower.

FHFA

On July 6, 2010, Fannie Mae and Freddie Mac stated that they would no longer purchase mortgage loans secured by properties with outstanding PACE loans. The FHFA announcement states:

> "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. The size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.

> FHFA urged state and local governments to reconsider these programs and continues to call for a pause in such programs so concerns can be addressed. 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."

The State of California and several other parties sued FHFA for not conducting a formal rulemaking before its decision; however, the 9th Circuit Court of Appeals ruled in FHFA's favor in March of 2013. (County of Sonoma, et al. v. Federal Housing Finance Agency, 710 F.3d 987 (2013)).

On December 22, 2014, the FHFA once again alerted homeowners, financial institutions, and state authorities of FHFAs concerns with state-level that threaten the first-lien status of single-family loans owned or guaranteed by Fannie Mae and Freddie Mac. FHFA stated,

> *"The existence of these super-priority liens increases the risk of losses to taxpayers. Fannie Mae and Freddie Mac, while operating in conservatorship, currently support the housing finance market by purchasing, guaranteeing, and securitizing single-family mortgages. One of the bedrock principles in this process is that the mortgages supported by Fannie Mae and Freddie Mac must remain in first-lien position, meaning that they have first priority in receiving the proceeds from selling a house in foreclosure. As a result, any lien from a loan added after origination should not be able to jump in line ahead of a Fannie Mae or Freddie Mac mortgage to collect the proceeds of the sale of a foreclosed property. Localities offering these PACE loans threaten to move existing Fannie Mae and Freddie Mac mortgages to a second lien position and increase the risk of loss to the Enterprises and, by extension, to taxpayers.*
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> *In issuing this statement, FHFA wants to make clear to homeowners, lenders, other financial institutions, state officials, and the public that Fannie Mae and Freddie Mac's policies prohibit the purchase of a mortgage where the property has a first-lien PACE loan attached to it. This restriction has two potential implications for borrowers. First, a homeowner with a first-lien PACE loan cannot refinance their existing mortgage with a Fannie Mae or Freddie Mac mortgage. Second, anyone wanting to buy a home that already has a first-lien PACE loan cannot use a Fannie Mae or Freddie Mac loan for the purchase. These restrictions may reduce the marketability of the house or require the homeowner to pay off the PACE loan before selling the house."*

California PACE Loss Reserve Program (LRP)

In 2013, Senate Bill 96 (Budget Committee), directed CAEATFA to develop the PACE LRP to mitigate the potential risk to mortgage lenders associated with residential PACE financing. The $10 million Loss Reserve makes the first mortgage lenders whole for any losses in a foreclosure or a forced sale that are attributable to a PACE lien covered under the LRP. The goal of the LRP is to put first mortgage lenders in the same position they would be in without a PACE lien.

PACE administrators can participate in the LRP by applying to CAEATFA and demonstrating that they meet the LRP's minimum underwriting criteria. Once a PACE program is enrolled, the Loss Reserve will cover assessments issued by that program for their full terms, or until funds are exhausted. Enrolled PACE programs report their financing activity to CAEATFA semi-annually. To date, no claims have been made on the LRP.

In May of 2014, FHFA responded to California's PACE LRP by stating,

> "FHFA has carefully reviewed the Reserve Fund created by the State of California and while, I appreciate that it is intended to mitigate these increased losses, it fails to offer full loss protection to the Enterprises. The Reserve Fund is not an adequate substitute for Enterprise mortgages maintaining a first lien position and FHFA also has concerns about the Reserve Fund's ongoing sustainability."

Department of Housing and Urban Development- FHA

In August, 2015, FHA announced the development of Single Family PACE guidance. The Single Family FHA guidance will address the impact of PACE assessments on purchases, refinances and loan modification options available to borrowers experiencing distress and will require subordination of PACE financing to the first lien FHA mortgage. FHA stated the guidance at a minimum will include the following:

- Lien position: only PACE liens that preserve payment priority for first lien mortgages through subordination;
- PACE payment, structure, and term: PACE financing must be fixed rate, fully amortizing loan;
- Eligible properties: PACE assessments must be attached to single family properties, as defined by FHA, which are 1 to 4-unit dwellings, including detached, semi-detached and townhome properties;
- Equity requirements: PACE liens that preserve payment priority for first lien mortgages will be eligible for financing that does not exceed FHA's maximum combined loan-to-value ratio;
- Record keeping: PACE liens must be formally recorded and be identifiable to a mortgage lender through a title search;
- Additional consumer protections: PACE programs must comply with applicable federal and state consumer laws and should include disclosures to and training for homeowners participating in the program.

Concerns with PACE:

The following are concerns with the current administration of the PACE program:

Refinancing: A person with a traditional PACE lien which has super priority status may not be able to obtain refinancing with a loan which conforms to current Fannie Mae or Freddie Mac guidelines, which represents the vast majority of conventional refinancing. Fannie Mae and Freddie Mac policies prohibit them from purchasing a mortgage with a PACE lien on it. This greatly limits, if not eliminates, the ability of a borrower to refinance the property if there is a PACE super priority lien. Certain programs have advertised that many homeowners have been able to refinance their property with PACE liens, but it is likely most of those were done prior to July 6, 2010 or the homeowners are using non-conventional financing which may carry higher interest rates.

Selling: A homeowner with a PACE lien may have difficulty selling his or her property to buyers with conventional loans. Fannie Mae and Freddie Mac are prohibited from purchasing a mortgage with a PACE lien on it. Therefore a buyer who is using conventional financing will likely be unable to purchase a home with the lien, as most conventional mortgages will conform to Fannie Mae and Freddie Mac guidelines. Sellers would be limited to those persons who are cash buyers, or buyers who have loans from lenders who make loans which do not conform to Fannie Mae or Freddie Mac guidelines and only where such loans omit provisions restricting the ability to borrow with the super priority lien.

Senior Lien/Lien Subordination: The voluntary contractual assessments that borrowers enter into result in a senior lien on the property. A lien occurs when an assessment, obligation, or claim (debt) is secured by the value of your property, such as a mortgage. The lien attached to a property in connection with the contractual assessment has "senior" lien status, which means that it has priority and must be satisfied before any other private liens, including a mortgage. The foreclosure of a property subject to a senior lien will terminate all other liens on the property with a lower priority. A number of PACE programs are offering to subordinate PACE liens at the request of a homeowner. Lien subordination is the industry response to FHFA and FHA but it is unclear how it works, how it is offered and how it impacts the PACE program.

Lack of consumer protections: The current PACE program lacks disclosure requirements in statute. Borrowers should fully understand these restrictions prior to taking out a first-lien PACE loan. PACE loan underwriting conducted by public agencies or private entities lacks basic standards with federal lending laws. Potential borrowers are not evaluated for their ability to repay, there are insufficient parameters for debt-to-income or loan-to-value ratios, and consumer disclosures are inadequate failing to clearly identify the terms and conditions of the loan and the subsequent impact such loans have on existing mortgages and the consumer's ability to sell or refinance their home.

Number of PACE Loans: It is also unclear how many PACE loans can be made on a single parcel. A single property may therefore have a super-priority lien established for a loan made for solar efficiency, a separate loan for water efficiency and a third loan for seismic strengthening improvements. The potential stacking of these PACE loans further complicates title and the rights of other prior lienholders.

Oversight: Currently, the PACE program lacks oversight and regulatory enforcement. These newly created third party providers have no regulator to ensure consumers are provided with necessary disclosures and protections. This hearing will examine the oversight that is being provided by local governments, including JPAs, on the practices of contractors, the relationship between third party providers and contractors.

PACE Financing:

PACE was created as a financing alternative for homeowners in hopes of encouraging energy efficiency across the state. Homeowners can use PACE for various energy efficiency improvements such as solar panels, irrigation components, windows, HVAC systems, etc. PACE allows a homeowner to apply for PACE financing, if approved the money financed runs with the property rather than the homeowner for up to 20 years. PACE providers encourage homeowners to participate by telling them PACE is:

- Easy and simple to qualify
- Adds value to the home
- Financing is not based on the owner's annual income
- Assessments do not appear on your credit report - personal credit score has no impact on funding eligibility or interest rate
- Assessments are paid semi-annually along with your property taxes
- Assessments may be passed to subsequent property owners
- 0% down- 100% financing- no payment until December 2017
- Terms and tax advantages deliver the lowest monthly payments – saving you 50% or more over traditional financing.

Prepayment penalties: According to the Sonoma County program: initial bond financing for improvements is held by the Sonoma County Treasury, and there is no penalty while the County Treasury holds the note. However, in order to continue to provide funding for Program growth, this investment will at some point be converted to long-term bonds. Bond purchasers generally require an early payment penalty/premium of up to 3%, based on current conditions. Please note that while a homeowner can pay off the assessment completely, the County of Sonoma cannot accept partial prepayments. Because PACE Financing is through the sale of bonds, any early payoff would need to include interest due until the next semi-annual bond payment date, which under state law is either March 2 or September 2.

Interest rates: Interest rates vary depending on the program, but tend to be higher than they would be for home equity loans. A review of various programs showed rates in a range from 6.95 to 9.25% which varied on a number of factors including the amount borrowed, and the duration of the assessment.

Conclusion:

The value and importance of the PACE program to the state of California does not need to be debated. Thus far, the PACE program has allowed thousands of homeowners afford energy efficient upgrades that homeowners may not have otherwise been able to afford. To address the unintended concerns (discussed above), during the 2016 legislative session, AB 2693 was introduced to require a uniform disclosure form and additional much needed consumer protections. As the PACE program enters its 10 year anniversary and as we approach the next housing cycle, California needs to be prepared for the next wave of foreclosures with PACE liens attached to them.

In the News:

- Mark Chacon: Energy-efficiency loans could cause homeowner headaches

Even if you can afford to pay off the liens before the sale closes, that reduces the amount you can realize from the sale. And even if you find an all-cash buyer, because the assessment will transfer with the property, that's an added cost many prospective buyers won't want to deal with.

Steve Lista found that out the hard way. He put his five-bedroom home in Riverside County on the market in June but couldn't find a buyer willing to take on the $3,000-a-year assessment for his $27,000 solar panel system.

(http://www.vcstar.com/opinion/columnists/mark-chacon-energy-efficiency-loans-could-cause-homeowner-headaches-2f20c692-4bb8-17c7-e053-0100007f-375102471.html)

- Energy improvement program can hobble home sales

When Patti Smith sought a refinance last year for her senior community home in San Diego County, she had to pay off a $14,774 HERO loan she previously took out for an air-conditioning unit, tankless water heater and replacement ductwork.

"I was flabbergasted when our mortgage company told us we had a lien," said Smith, 62. "The contractor who pushed the HERO program never mentioned the word 'lien.' If he would have we would have never done it."

Smith said she also had to pay a penalty of $1,734.14 to HERO for paying off the loan early. The HERO program has since waived the penalty fee for homeowners.

(http://www.sacbee.com/news/business/real-estate-news/article27528559.html#storylink=cpy)

- A Growing Green Debt?

Last September, Erin Stumpf of Dunnigan Realtors met with a homeowner in Sacramento's Tallac Village neighborhood. The owner wanted to sell, and she'd replaced her yard with artificial turf, taking out a $7,000 PACE loan to do it. "Oh, but don't worry," the homeowner told Stumpf. "The PACE loan will be transferred to the new owner."

Stumpf had to explain that wasn't true. The prospective buyer likely wouldn't be able to get a mortgage because of the PACE loan — Fannie Mae and Freddie Mac, which guarantee 90 percent of the country's home loans, won't do so for properties with a PACE lien. The seller fortunately had enough home equity and used it to pay off her turf at the time of the sale.

Because she cleared her loan early, she was also hit with a prepayment penalty of at least $800, Stumpf says. "The way this was sold to my client and the way that it's sold to the public in general is really misleading," Stumpf says.

(http://www.comstocksmag.com/article/growing-green-debt)

- Clean Energy Loans Make Sales Messy- Wall Street Journal- 11/7/2015

Lori Laine's foray into a California clean-energy program made it tough for her to sell her house and ended up costing her hundreds of dollars and months of aggravation.

The culprit: a nearly $8,000 loan she took out last year to pay for a new air-conditioning unit to replace her broken one, part of a statewide push to promote clean energy with low-interest loans.

"I would never do this again," Ms. Laine said.

Ms. Laine said her air-conditioning contractor told her the financing would transfer to a new owner if she sold the home, though she admits the documents she signed from San Diego-based lender Renovate America Inc. stated there could be difficulties.

When she tried to sell her Highland, Calif., home last October, the buyer said Ms. Laine would need to pay off the balance in full before the buyer could get a mortgage.

Ms. Laine took the home off the market in hopes the rules would change, but earlier this year, she gave in and paid it off in order to sell the house.

PACE Legislation:

AB 2693 (Dababneh) would add consumer protections to the PACE program by requiring a unified disclosure. Set to be heard in Senate Governance and Finance on June 15.

AB 2597 (Ting, Chapter 614, Statutes of 2014) revised the CAEATFA underwriting standard for the PACE program by increasing the maximum amount of an assessment from 10 percent to 15 percent of the property value and specifies that PACE financing is an "assessment" or "financing" (as appropriate) and not a "loan."

AB 1883 (Skinner, Chapter 599, Statutes of 2014) allowed a public agency to transfer voluntary contractual assessments, if bonds have not been issued, as specified.

SB 96 (Committee on Budget and Fiscal Review, Chapter 356, Statutes of 2013) required the California Alternative Energy and Advanced Transportation Financing Authority to develop and administer a risk mitigation program for PACE loans.

SB 555 (Hancock, Chapter 493, Statutes of 2011) added the acquisition, installation, and improvement of energy efficiency, water conservation, and renewable energy improvements that are affixed to the types of facilities that a community facilities district (CFD) may finance, or refinance, regardless of whether the buildings or property are privately or publicly owned.

SB 1340 (Kehoe, Chapter 649, Statutes of 2010) expanded the use of voluntary contractual assessments to finance electric vehicle charging infrastructure and correspondingly expanded the PACE bond reserve program.

SB 77 (Pavley, Chapter 15, Statutes of 2010) authorized CAEATFA to develop and administer a state PACE bond reserve program to pay bondholders in the event a PACE program had insufficient funds, which would reduce risk to bondholders and facilitate smaller interest rates. CAEATFA has suspended development of this program pending resolution of FHFA's concerns described above.

AB 44 (Blakeslee, Chapter 564, Statutes of 2010) expanded the use of voluntary contractual assessments to include financing of power purchase agreements, and prohibited contractual assessments if the total amount of the assessments and taxes on the property exceeds 5% of the property's market value.

AB 474 (Blumenfield, Chapter 444, Statutes of 2009) expanded local agencies' PACE authorization to include water efficiency projects.

AB 811 (Levine, Chapter 159, Statutes of 2008) authorized all cities and counties in California to designate areas within which city officials and willing property owners may enter into contractual assessments to finance the installation of distributed generation renewable energy sources and energy efficiency improvements.