

ADMINISTRATIVE LAW REVIEW

ACCORD

Volume 67

Comment

CALIFORNIA CAN BEAT FHFA'S PACE: HOW THE RESERVE FUND MODEL CAN REVIVE RESIDENTIAL PACE LOANS

JOHN CHARIN

TABLE OF CONTENTS

Introduction.....	54
I.PACE Programs	57
II.Residential PACE Lien Structures Must Facilitate Payment of Mortgage Lenders.....	61
A. FHFA Considers Senior Lien Priority for PACE Loans Risky for Mortgage Lenders	62
B. California's Reserve Fund Allows Senior Liens to Continue While Ensuring Repayment of Federal Mortgage Associations	64
C. Other States' Attempts to Restructure Lien Priority Dampen Lending.....	66
III.Residential PACE Programs Must Facilitate Stable Underwriting.....	67
A. FHFA Concludes that Underwriting for PACE Loans is Unconventional and Destabilizing.....	68
B. California's Reserve Fund Model Will Establish Underwriting Guidelines and Pay the Difference in the Event of a Default	69
C. The California Reserve Fund Model Insures Lenders	

Against Risk While Facilitating Appealing Localized Underwriting Standards	70
IV.Recommendations for Implementing and Improving the Reserve Fund Model	72
Conclusion	75

INTRODUCTION

Reducing greenhouse gas emissions, achieving energy independence, and fostering sustainable development were ubiquitous parts of the political landscape by the 2008 presidential election,¹ but these national ambitions were forced to compete against the economic realities left by the housing bubble collapse and foreclosure crisis of 2007.² The biggest challenge to implementing sustainability is overcoming the formidable up-front costs, even when investment in clean energy is likely to save money in the long term.³ Property Assessed Clean Energy (PACE) loans emerged in 2007 as a creative solution to the up-front financial obstacles of sustainable building.⁴ Since its origination, PACE has been adopted in twenty-six states and the District of Columbia and has provided a way to fund clean energy building projects and upgrades.⁵

PACE loans provide attractive financing for renewable energy upgrades by allowing the recipient to pay back the loan gradually via property tax assessments.⁶ Specifically, in exchange for a loan to cover clean and

1. See *The Second Presidential Debate*, N.Y. TIMES, Oct. 7, 2008, <http://elections.nytimes.com/2008/president/debates/transcripts/second-presidential-debate.html> (mentioning clean energy and related topics numerous times throughout the debate).

2. See generally *id.* (conveying that economic issues dominated the responses of then-Senator Barack Obama and Senator John McCain at the presidential debate).

3. See U.S. ENERGY INFO. ADMIN., *Renewable Energy Explained*, EIA.GOV, http://www.eia.gov/energyexplained/index.cfm?page=renewable_home (last visited Apr. 2, 2015) (explaining that prohibitive costs have restricted widespread implementation of renewable energy sources); Jon Creyts et al., Executive Summary, *Reducing U.S. Greenhouse Gas Emissions: How Much at What Cost?*, MCKINSEY & CO., at ix–xiv (2007), available at http://www.mckinsey.com/~media/mckinsey/dotcom/client_service/sustainability/pdfs/reducing%20us%20greenhouse%20gas%20emissions/greenhouse_gas_emissions_executive_summary.ashx (concluding that despite significant expressed support and the perceived benefits of clean energy upgrades, the front-end costs dissuade large scale acceptance).

4. See James M. Van Nostrand, *Legal Issues in Financing Energy Efficiency: Creative Solutions for Funding the Initial Capital Costs of Investments in Energy Efficiency Measures*, 2 GEO. WASH. J. ENERGY & ENVTL. L. 1, 3–5 (2011) (describing the creation of Property Assessed Clean Energy (PACE) in Berkeley, California).

5. See *List of PACE Programs*, PACENOW, <http://www.pacenow.org/resources/all-programs/> (last visited Apr. 4, 2015).

6. See *What is PACE?*, PACENOW, <http://pacenow.org/about-pace/what-is-pace/>

renewable energy retrofits, property owners receive a special tax assessment that factors in the increase of home equity resulting from the upgrade and are allowed to pay back principal and interest over periodic tax payments.⁷ Moreover, PACE loans are evaluated and underwritten based on the increase to the property's equity that results from the upgrades, which provides access to funds where owners might not have the credit or capital they need to qualify for a more conventional loan of the same size.⁸ Also, because repayment of PACE loans is built into the property tax assessment, the tax obligation passes to the purchaser if the property is transferred before the loan is fully repaid, and the seller does not have to pay for the future equity he foregoes by transferring.⁹ As a result, PACE loans became popular quickly, as they provide a way for property owners to access expensive clean energy retrofits without requiring a large up-front capital investment¹⁰

Shortly after the emergence of PACE loans, the Federal Housing Finance Agency (FHFA) was established in 2008 against the backdrop of the mortgage crisis, showing that increasing stability in mortgage borrowing became a major national priority.¹¹ On July 6, 2010, FHFA issued a statement that effectively ended PACE in the residential context.¹² FHFA announced its determination that PACE loans were unacceptably risky for residential lenders, and advised Fannie Mae (Fannie) and Freddie Mac (Freddie) to avoid mortgages associated with PACE assessments, while further threatening to intervene if communities continued residential PACE as it existed at the time.¹³ Although the 2010 statement did not fully close

(last visited Sept. 14, 2014). For an overview of the history and structure of PACE programs, see Jeffrey Hoops, Note, *Setting the PACE For Energy Efficiency: The Rise, Fall, and (Potential) Return of Property Assessed Clean Energy*, 89 WASH. U. L. REV. 901 (2012).

7. An example of clean and renewable energy retrofits to existing houses is solar panel additions. Hoops, *supra* note 6, at 904–05 (detailing how PACE loans are paid back by increasing property taxes to account for the increase in home equity as a result of the upgrade, with an amortization period of ten to twenty years to make up the principal).

8. *See id.* at 906–07.

9. *See* Hoops, *supra* note 6, at 906; *see, e.g.*, 2011 CONN. ACTS 11–80 § 100, available at <http://www.cga.ct.gov/2011/ACT/PA/2011PA-00080-R00SB-01243-PA.htm> (showing an example of the statutory basis of the tax assessment structure).

10. *See id.* at 906–07.

11. Federal Housing Finance Agency (FHFA) was established to create and implement rules for mortgage lenders and oversee the secondary mortgage market. *See generally* Housing and Economic Recovery Act of 2008, 12 USC § 4511 (2012).

12. *See* FED. HOUS. FIN. AGENCY, *Statement on Certain Energy Retrofit Loan Programs* (July 6, 2010), available at <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Statement-on-Certain-Energy-Retrofit-Loan-Programs.aspx> [hereinafter *July 6 Statement*]; Hoops, *supra* note 6, at 902 (“[T]his action effectively killed residential PACE programs throughout the country.”).

13. *July 6 Statement*, *supra* note 12; *see infra* Section II (explaining the risk perceived by

the door to residential PACE programs,¹⁴ it condemned certain fundamental aspects of the structure of PACE loans and left proponents of residential PACE to puzzle over how to provide programs that could satisfy or circumvent the new federal policy.¹⁵

Several alternatives have been attempted or advocated as a means to provide the benefits of residential PACE without running afoul of FHFA, each sacrificing some of PACE's most attractive features to do so.¹⁶ Recently, California Governor Edmund Brown sent a letter to FHFA outlining a plan to establish a state reserve fund that will back PACE loans and make Fannie and Freddie Mac whole in the event of default.¹⁷ FHFA Director Melvin Watt responded with a letter stating that California's \$10 million proposal was not sufficient to cover the risk,¹⁸ but FHFA may have tacitly endorsed the fundamental concept by not rejecting it outright, providing hope for advocates of the reserve fund model.¹⁹

Part I of this Comment provides a background on PACE programs and the 2007 housing and foreclosure crisis. Part II examines the lien priority

FHFA).

14. See *July 6 Statement*, *supra* note 12 (presenting an effects-based critique while avoiding an outright ban on PACE loans, and further asserting that FHFA remains open to accepting PACE programs that prevent the Agency's primary concerns).

15. See Kat Friedrich, *Residential PACE Energy Programs Pursue Innovative Approaches*, RENEWABLE ENERGY WORLD (2013), <http://www.renewableenergyworld.com/rea/news/article/2013/09/residential-pace-energy-programs-pursue-innovative-approaches> (describing how various states responded to the 2010 Decision, including providing junior liens which are noted to be less attractive to investors).

16. *Id.* (summarizing various state alternatives to residential PACE and how they operate in the wake of the 2010 Decision).

17. Letter from Edmund G. Brown, Gov. of Cal., to Edward DeMarco, FHFA Acting Dir. (Sept. 23, 2013), *available at* <http://votesolar.org/wp-content/uploads/2013/09/PACE-Governors-Letter.pdf>.

18. Letter from Melvin Watt, FHFA Dir., to Edmund Brown, Gov. of Cal. (May 1, 2014), *available at* http://file.lacounty.gov/bc/q2_2014/cms1_213127.pdf [hereinafter WATT]. Watt's letter succinctly states that FHFA disapproves of California's proposal as presented in Governor Brown's letter. Watt explains that the \$10 million reserve fund is not sufficient to cover lien priority concerns. This letter represents FHFA's formal rejection of the California proposal. However, little explanation is given and the letter does not reject the fundamentals of the proposal. Because Watt's letter is so brief, and echoes the statements in the July 6 Statement, it is useful to analyze the policy concerns there. See *supra* note 12.

19. Stephen Lacey, *Why Residential PACE is Growing in Spite of Opposition From Federal Housing Lenders*, GREENTECH MEDIA (July 24, 2014), <http://www.greentechmedia.com/articles/read/Why-Residential-PACE-Is-Growing> (determining that FHFA's letter was a soft rejection that simply lacked the funding to win FHFA's approval); John Farrell, *California's Reserve Fund Won't Lift the FHFA Boot from PACE's Neck*, INSTITUTE FOR LOCAL SELF RELIANCE (July 15, 2014), <http://www.ilsr.org/californias-pace-program-solve-fanniefreddie-problem> (same).

concern that served as a basis for FHFA's 2010 Decision. In addition, Part II explores California's reserve fund approach to overcoming that issue, and compares California's approach to attempts made by other states. Part III examines FHFA's underwriting concerns, and discusses how California attempts to ameliorate those concerns. Part IV recommends methods for implementing a reserve fund system like the California model, offering additional features to help overcome the deficiencies and concerns that led to FHFA's rejection of the program. This Comment concludes that despite FHFA's recent rejection of California's specific proposal, the California model would offer the most effective solution for each of FHFA's concerns with some slight modifications, and such a model should be emulated by other states and accepted by FHFA.

I. PACE PROGRAMS

PACE loans began in Berkeley, California in 2007.²⁰ California had lofty clean energy and energy efficiency goals, but there were several barriers to the widespread implementation of retrofits.²¹ Clean energy retrofits save the user money, and can potentially pay for themselves in the long run.²² However, these upgrades can be expensive and it may take years for the upgrades to generate enough savings to offset the upfront costs.²³

PACE offered a solution to the financing issues inhibiting large-scale clean energy retrofits.²⁴ PACE provides long term loans for clean energy retrofits, or in some cases, energy efficiency upgrades.²⁵ Homeowners get access to funds for making expensive upgrades such as installation of photovoltaic systems.²⁶

Under PACE, a state first enacts enabling legislation, and then local governments issue low interest bonds to generate program funds.²⁷ The local government offers funds to homeowners for clean energy or energy

20. Hoops, *supra* note 6, at 906 (beginning in 2007, Berkeley was the first municipality to offer PACE loans, and California passed state-wide PACE-enabling legislation in 2008).

21. See E. Gail Suchman & Micah Bloomfield, *Property Assessed Clean Energy (PACE): Emerging Technique for Financing Energy Efficiency Encounters New Obstacles*, STROOCK (2010), available at <https://www.stroock.com/SiteFiles/Pub987.pdf> (positing that PACE emerged as a response to early barriers to the wide implementation of California's clean energy goals, and a new lending model was necessary to overcome the upfront costs at the time).

22. See *id.* (suggesting that the upgrades covered by PACE loans will tend to generate savings over a long enough life span).

23. *Id.*

24. See Hoops, *supra* note 6, at 904.

25. *Id.*

26. *Id.* at 904 n. 20.

27. Suchman & Bloomfield, *supra* note 21.

efficient upgrades, generally acting as a lender.²⁸ The bond format allows local taxpayers to decide whether they want to offer PACE loans and to determine how much to allow for the program. Homeowners get a special property tax assessment, which typically results in an up to twenty-year plan for repayment of the loan.²⁹ Tax assessments pass to the next property owner if the property is transferred.³⁰ Because the ability to repay comes from the upgrade to the property, PACE lenders are able to make the loan based on the expected value of the energy savings and resulting equity increase to the property rather than focus strictly on the recipient's income.³¹

Homeowners appreciate the structure of PACE because outstanding debt on tax obligations do not accelerate in the event of a default, unlike in a typical mortgage.³² Additionally, payments tied to municipal bond rates provide cheaper financing than ordinary market rates.³³ The borrower also has the advantage of going to only one lender, adding certainty and extending the benefits of consolidated expertise.³⁴ These advantages could help the single lender system reduce the cost of transacting.

28. *Id.*; see also *List of PACE Programs*, PACENow, <http://pacenow.org/resources/all-programs/> (last visited Sept. 26, 2014) (providing a list of PACE programs with brief descriptions updated to reflect changes in law, and describing some programs that incorporate other entities for lending).

29. See Suchman & Bloomfield, *supra* note 21; see also Prentiss Cox, *Keeping PACE? The Case Against Property Assessed Clean Energy Financing Programs*, 83 U. COLO. L. REV. 83, 92 (2011). Twenty years is a typical PACE loan term, although this period can vary. *Id.*

30. Hoops, *supra* note 6, at 906.

31. See *id.* (explaining that the ability to lend on energy savings may allow the borrower to repay based wholly on energy savings and increased property value, simplifying underwriting. A borrower does not necessarily need the income to cover this type of loan because the value of her property should increase based on the installation and provide the funds to pay back the loan if needed. Additionally, the tax assessment stays with the house, so if a borrower cannot repay, then the next buyer of her house would repay it in property taxes); see also, Suchman & Bloomfield, *supra* note 21 (stating that some municipalities employ laws to facilitate conservative underwriting techniques, requiring a positive cash flow, and offering funds only if the energy savings from a PACE upgrade will exceed the tax assessment). But see *July 6 Statement*, *supra* note 12 (arguing that the tax assessment structure causes loans to be made on collateral rather than on ability to repay through savings and income, which is destabilizing).

32. Suchman & Bloomfield, *supra* note 21 at 1–2.

33. Michael A. Wrapp, Note, *PACE: Victim of Loan Giants or Way of the Future?* 27 NOTRE DAME J.L. ETHICS & PUB. POL'Y 273, 276 (2013).

34. See E. Gail Suchman et al., *A Tale of Two PACEs: Commercial Success vs. Residential Repose*, STROOCK SPECIAL BULLETIN (Mar. 15, 2013), <http://www.stroock.com/SiteFiles/Pub1306.pdf> (asserting that the consolidation of PACE lending in a single municipal body concentrates expertise, and allows borrowers to benefit from a more knowledgeable staff).

PACE can, however, complicate mortgages.³⁵ Most homebuyers take out mortgages to pay for the purchase property.³⁶ In a typical transaction, a mortgage lender will provide a loan, and the property will likely secure the loan.³⁷ In other words, although lenders will make loans based on the borrower's income, the lender can use the property to recover the outstanding amount of his or her loan in the event of default.³⁸ Depending on the jurisdiction, the lender will either obtain a lien, which then he can sell the property to recover, or the lender can take title of the property.³⁹ The lien against the title is recorded in whatever office covers land records, which provides notice to any future lenders.⁴⁰

Liens on mortgaged properties can become complicated when multiple liens arise against the same property.⁴¹ A borrower can use his or her equity in the property to secure multiple loans, which occurs when the value of the property increases from the time of purchase and allows for credit beyond the value of the mortgage loan.⁴² The key to mortgage lending is the fact that the mortgage lien is typically senior to other liens, meaning that if a property must be sold to pay back creditors, the mortgage lender's lien will be paid back first, and other lienholders can only recoup the remaining proceeds.⁴³ However, there are some cases in which a newer

35. *See id.*

36. *See* Alejandro Lazo, *Nearly One-Third of U.S. Homeowners Have No Mortgage*, L.A. TIMES, Jan. 10, 2013, <http://articles.latimes.com/2013/jan/10/business/la-fi-free-and-clear-20130110> (reporting that approximately one-third of homes in the United States are owned free and clear of debt, which includes both mortgages already paid off and homes bought with cash, inferring that more than two-thirds were purchased with a mortgage at one time).

37. *See* GEORGE LEFCOE, REAL ESTATE TRANSACTIONS 175–76 (6th ed., 2009).

38. *See id.* at 174–76 (outlining the major criteria mortgage lenders use to underwrite and evaluate potential loans, generally described by ratios as loan amount to value of the property and borrower's income and assets).

39. *See id.* at 410–11 (discussing the foreclosure processes of “title theory” and “lien theory” states).

40. *Id.* at 175.

41. *See* LEFCOE, *supra* note 37, at 393–99 (summarizing the ways liens can compete with a mortgage lien. Common liens against properties include mechanic's liens, tax liens, builder's liens, and other liens from various creditors).

42. *See id.* at 237–39 (describing how mortgagors take on debt secured by properties that are already mortgaged based on appreciation of the property's value).

43. *See id.* The principles of mortgage liens are essential because the mortgage lender makes very large loans and can only use the value of the security property to determine the ability to collect the outstanding loan balance. The original mortgage lender evaluates a potential loan based on the borrower's position at the time of the purchase, and needs the security property to back the loan in the event that the borrower takes out a significant amount of debt after making the purchase. Later creditors are able to discover the first mortgage lender's lien and determine whether the borrower has the ability to cover payments on both loans and whether there will be enough collateral in the borrower's

lien can become senior to a mortgage lien.⁴⁴ Real property tax liens are the quintessential example of intervening senior liens,⁴⁵ and introduce risk to mortgage lending.⁴⁶ When a mortgagor defaults on his mortgage payments and the mortgagee forecloses, the proceeds from the foreclosure sale would go toward paying an outstanding tax bill first, then the lender has to use whatever is left to recoup his loan.⁴⁷ If the mortgagor goes bankrupt, then junior creditors may not have any way of recovering.⁴⁸

Homeowners and the market at large have shown a great deal of support for PACE.⁴⁹ Local governments and other advocates argue that PACE has provided much needed economic growth.⁵⁰ At least thirty-one states and the District of Columbia have enacted PACE enabling legislation, showing a general eagerness to offer PACE programs.⁵¹

In July of 2010, the FHFA issued the 2010 Decision directing lenders to avoid issuing and buying mortgages to homes with PACE loans,⁵² effectively ending residential PACE.⁵³ The foreclosure crisis of 2007 was largely characterized by instability and bank failure as borrowers were unable to pay mortgages, and the collapse of home equity prevented mortgage lenders and holders of secondary mortgage products from recouping the value of their loans in foreclosure.⁵⁴ Mortgages were being made too readily on the expectation of increasing home equity, and underwriting was done too liberally, in addition to more nefarious lending

property to collect after the first mortgage lender is repaid. *See id.*

44. LEFCOE, *supra* note 37, at 238-39 (providing some examples of liens that can supersede a preexisting mortgage lien, including property tax liens).

45. *E.g.*, CAL. REV. & TAX. CODE § 2192.1 (West 1993) (establishing that in California, “[every] tax declared . . . to be a lien on real property, . . . [has] priority over all other liens on the property, regardless of the time of their creation.”).

46. Wilson et al, *The Great PACE Controversy*, 25 PROB. & PROP. 38, 38-39 (2011) (asserting that PACE liens that can become senior to mortgage liens remove certainty from underwriting, and make the mortgages less marketable on the secondary mortgage market).

47. *Id.* at 39.

48. LEFCOE, *supra* note 37, at 238-39.

49. Suchman et al., *supra* note 34, at 2 (stating that PACE received widespread support and created benefits for homeowners, the environment, and the economy).

50. *Id.* (arguing that municipalities largely support PACE on the prospect of attracting spending, and extrapolating data to suggest that widespread national implementation of PACE would generate “\$15 billion in gross economic output, \$4 billion in aggregate tax revenue, and 226,000 jobs.”).

51. *LIST OF PACE PROGRAMS*, *supra* note 28 (listing PACE Programs, though the majority of these are commercial and not residential).

52. *July 6 Statement*, *supra* note 12.

53. *See* Suchman et al., *supra* note 34, at 2.

54. *See The Origins of the Financial Crisis: Crash Course*, ECONOMIST, Sept. 7, 2013, available at <http://www.economist.com/node/21584534/print> (providing an overview of the foreclosure crisis and economic malaise).

practices.⁵⁵ In the end, the effect on secondary mortgage markets was the most damaging to the economy.⁵⁶

With banks unable to collect outstanding loan balances through foreclosure sales, there was less capital available for lending and the economy at large faltered.⁵⁷ Furthermore, the instability and lack of certainty about the viability of mortgage portfolios made banks unwilling to lend the money they did have, and drove down their values.⁵⁸ In 2010, with the effects of the financial crisis still being felt, FHFA suspended residential PACE, arguing that residential PACE created the types of nonpayment risks for mortgage lenders and instability in mortgage markets that caused the 2008 financial crisis.⁵⁹

II. RESIDENTIAL PACE-ENABLING LEGISLATION MUST FACILITATE PAYMENT OF MORTGAGE LENDERS

FHFA's biggest concern about PACE arises from the fact that tax obligations typically create liens that are senior to mortgage liens.⁶⁰ Since the tax liens are satisfied before mortgage liens, using tax assessments to pay back loans risks diminishing the amount left for federal mortgage holders to recover in the event of default and foreclosure.⁶¹ The California reserve fund model attempts to address this concern by using state funds to pay the

55. *See id.*

56. *See id.* (describing the massive losses incurred over derivatives and worthless mortgage-backed debt portfolios); *see also* Robbie Whelan & Ruth Simon, *Mortgage Investors Are Set for More Pain*, WALL ST. J., Oct. 6, 2010, http://www.wsj.com/news/articles/SB10001424052748703843804575534303696918076?mod=_newsreel_2 (reporting that mortgage bond instruments were hit the hardest by the financial crisis, caused conflict between primary and secondary lienholders, and describing the precarious position of various debt holders. Many mortgages had been issued on dangerously high, speculative loan-to-value ratios, and mortgage debt values plummeted when home values fell. Junior debt holders were forced to either collect whatever money might be left after senior debt holders foreclose. However, senior debt holders who are unable to foreclose quickly may be forced to make payments to the junior debt holders in order to hold the property until such time as foreclosure is legal or might be more lucrative).

57. *See* ECONOMIST, *supra* note 54.

58. *See id.*

59. *See July 6 Statement, supra* note 12; *see also* Whelan & Simon, *supra* note 56 (showing the economic context of FHFA's action).

60. *See July 6 Statement, supra* note 12 (emphasizing lien priority issues with particular vigor).

61. Wilson et al., *supra* note 46, at 38–39; Michael Swartz, *A White Paper on PACE Loans: Unconstitutional and Damaging to GSE's Such as Fannie Mae and Freddie Mac*, HENNIGAN, BENNETT & DORMAN, LLP (2010) at 5–7 (2010), *available at* <http://dockets.sandiego.gov/sirepub/cache/2/wmiucz5euf4jpidngcojkunc/19954610302014083135531.PDF> (discussing the risk of nonpayment to federal entities specifically, which buy mortgages that may be especially susceptible).

PACE liens in the case of default.⁶²

The principal criticism of residential PACE programs focuses on the fact that the tax liens created by PACE loans can harm the mortgage lender's ability to recover against the property.⁶³ In its 2010 Decision, FHFA states that it has determined that first liens for PACE loans "present significant risk to lenders and secondary market entities."⁶⁴ To satisfy FHFA's guidelines and to avoid alienating lenders,⁶⁵ any state attempting to implement a residential PACE program must ensure that it is structured to avoid the destabilizing problem of tax liens impeding recovery on mortgage liens.

A. FHFA Considers Senior Lien Priority for PACE Loans Risky for Mortgage Lenders

The determination that lien priority for residential PACE loans presents an unacceptable amount of risk is the first rationale that FHFA gives in the 2010 Decision for suspending residential PACE.⁶⁶ The determination cites "safety and soundness concerns,"⁶⁷ and further describes the loans as destabilizing.⁶⁸ FHFA directs federal mortgage associations to avoid such loans, effectively ending residential PACE by cutting off the largest secondary market for residential properties.⁶⁹

The destabilizing factor that FHFA perceives from lien priority is the notion that mortgage lenders enter mortgage agreements and then put the mortgages into the secondary market, and the financial positions of both primary and secondary mortgage holders relies on their ability to use the property to recoup their expectancy on the loan.⁷⁰ Specifically, if tax liens get paid first in a foreclosure, it raises the probability of a shortfall on the sale and the lender's inability to recover the outstanding loan balance.⁷¹ FHFA fears that uncertainty about the security property may harm mortgage lenders and precipitate a change in mortgage lending practices.⁷²

62. Barbara Boxer, *Letter to FHFA Acting Director DeMarco*, Sept. 23, 2013, available at <https://www.boxer.senate.gov/en/press/releases/092313.cfm> (last visited Sept. 14, 2014).

63. Cox, *supra* note 29, at 85–86.

64. *See July 6 Statement*, *supra* note 12.

65. Cox, *supra* note 29, at 85 (explaining that mortgage lenders lobbied federal regulators to express concern about PACE lien priority).

66. *See July 6 Statement*, *supra* note 12.

67. *Id.*

68. *Id.*; *see also* WATT, *supra* note 18 (applying the lien priority concern to the California reserve fund proposal).

69. Wrapp, *supra* note 33, at 284.

70. *See* LEFCOE, *supra* note 37, at 185–91.

71. *See* Wrapp, *supra* note 33, at 283–84; Hoops, *supra* note 6, at 908–10.

72. *See July 6 Statement*, *supra* note 12 (stating a concern about threatening "traditional mortgage lending practice"); *see also* Hoops, *supra* note 6, at 908–10 (describing the possible ill effects of underwriting for PACE without central standards or certainty about repayment).

Additionally, uncertainty about the reliability of foreclosure as a remedy for default could undermine the value of secondary market products.⁷³ The overarching fear is that instability in a recovering market could trigger the failure of mortgage markets and ultimately paralyze lending.⁷⁴

No announcement preceded the 2010 Decision to suspend residential PACE, and FHFA did not implement the customary notice of proposed rulemaking procedure.⁷⁵ Several communities litigated the issue in response, arguing that the policy was made without an adequate foundation and that FHFA was required to open a period of public comment.⁷⁶ The suit never examined the correctness of FHFA's determination about the riskiness of residential PACE, as the U.S. Court of Appeals for the Ninth Circuit found that FHFA was within its rights to issue the 2010 Decision without notice-and-comment and could not be sued.⁷⁷

Pending its appeal, FHFA issued an Advanced Notice of Proposed Rulemaking in January 2012.⁷⁸ During the period of public comment, thousands of comments were sent in favor of residential PACE.⁷⁹ Mortgage lenders tended to enter comments arguing against PACE.⁸⁰ Unfortunately for PACE supporters, when FHFA won on appeal, it won the right to forego the standard rulemaking process and did not have to continue with the period of public comment, leaving little recourse for critics to challenge the process leading to the 2010 Decision.⁸¹ Although FHFA states that it is still weighing the issue and the door is still open, in the wake of the ruling by the Ninth Circuit and the FHFA's May 2014 letter rejecting California's proposal, it appears that residential PACE

73. See Cox, *supra* note 29, at 86 (arguing that secondary markets reject mortgage products with PACE liens as evidenced by a reduced valuation).

74. See Swartz, *supra* note 61.

75. California ex rel. Harris v. Fed. Hous. Fin. Agency, No. C 10-03084 CW, 2011 WL 3794942, at *2 (N.D. Cal. Aug. 26, 2011).

76. *Id.*; See Cnty. of Sonoma v. Fed. Hous. Fin. Agency, 710 F.3d 987, 994-95 (9th Cir. 2013).

77. Cnty. of Sonoma v. Fed. Hous. Fin. Agency, 710 F.3d at 990-95 (reversing the district court's decision and holding that FHFA was acting validly within its role as a conservator when it issued its decision reflecting its determination, and was therefore immune from suit).

78. Mortgage Assets Affected by PACE Programs, 77 Fed. Reg. 3958 (Jan. 26, 2012) (to be codified at 12 C.F.R. pt. 1254).

79. See Suchman, Bloomfield & Snow, *supra* note 34, at 2 n.17 (stating that a majority of the public comments entered during the notice period were in favor of PACE).

80. *Id.* See, e.g., Enterprise Underwriting Standards, 77 Fed. Reg. 36,090 (June 15, 2012) (to be codified at 12 C.F.R. pt. 1254) (arguing that PACE frustrates Fannie Mae's underwriting). *But see id.* at 36089 ("Generally, these comments included support for PACE programs, noting their contribution to energy efficiency, environmental benefits, job creation, and other economic or climate benefits.").

81. See Cnty. of Sonoma, 710 F.3d. at 989-95.

programs must be structured to avoid the risk of nonpayment to federal mortgage associations if they are to survive.⁸²

B. California's Reserve Fund Allows Senior Liens to Continue While Ensuring Repayment of Federal Mortgage Associations

California's reserve fund model was designed to address FHFA's concerns about senior liens harming federal mortgage associations, while still maintaining the senior lien structure.⁸³ Under the California system, the state will set aside funds that would repay federal mortgage associations in the event that a senior lien from an outstanding balance on a PACE loan caused a shortfall in a foreclosure scenario.⁸⁴ The 2010 Statement specifically sets the policy against programs that contribute to the harmful effects of the liens rather than prohibiting the lien structure itself;⁸⁵ therefore, the reserve fund model proposed by California provides a clever solution to the prohibition of existing programs while still maintaining the lien structures that triggered the prohibition.⁸⁶

The reserve fund concept can circumvent nonpayment risks from senior liens by setting aside funds and holding them in proportion to the prospective liens. It bears noting that nonpayment risks are believed by many to be minimal⁸⁷ Although FHFA prohibits programs that allow PACE lien priority to introduce nonpayment risk to federal mortgage

82. See *July 6 Statement*, *supra* note 12; see also WATT, *supra* note 18 (making it clear that the FHFA will take action against any potential nonpayment risk arising from PACE loans). The July 6 Statement effectively kills California's \$10 million reserve fund proposal, but does not reject the fundamentals of the reserve fund system. See *July 6 Statement*, *supra* note 12 (addressing the specifics of California's proposal, but not offering any further commentary on the broader system).

83. Letter from Edmund G. Brown, *supra* note 17 (explaining that the reserve fund has been established to avoid the nonpayment risks that FHFA cites in the decision).

84. Letter from Edmund G. Brown, *supra* note 17; K. Kaufman, *PACE update: Gov. Brown Proposes State Back-up Fund to Counter FHFA Opposition*, DESERT SUN, Sept. 23, 2013, <http://voices.mydesert.com/2013/09/23/pace-update-gov-brown-proposes-state-back-up-fund-to-counter-fhfa-opposition/> (describing the structure of the reserve fund system and how it operates to make federal mortgage associations whole in the event that PACE loans cause a shortfall).

85. See *July 6 Statement*, *supra* note 12; see also WATT, *supra* note 18 (rejecting the \$10 million California proposal due to its failure to mitigate the risk, but not rejecting the reserve fund model outright).

86. See *id.* (prohibiting programs with a risk of nonpayment stemming from the lien structure).

87. See K. Kaufman, *Property Assessed Clean Energy (PACE) Financing Update*, URBAN LAND INSTITUTE (July 20, 2011), <http://urbanland.uli.org/economy-markets-trends/property-assessed-clean-energy-pace-financing-update/> (last visited Sept. 18, 2014) (concluding that leading studies suggest a very low risk of default associated with residential PACE properties).

associations and lenders, states can demonstrate that set-asides match the potential losses, which would expressly prove that the state takes all the risk from federal entities.⁸⁸

Further, the risks of nonpayment as a result of lien priority issues have been criticized as largely overblown.⁸⁹ Because the 2007 economic crisis precipitated the creation of the FHFA, the Agency's existence is premised on the need to reduce risk in the mortgage markets.⁹⁰ The crisis underscored the need to reduce the rates of defaults by mortgagors and nonpayment to mortgage holders.⁹¹ FHFA's seminal concern offers a reason to suggest that the Agency may be hypersensitive to possible risk.⁹² However, the data on default rates appear to undermine FHFA's concerns, and show a reduction in risk of default in correlation with residential PACE loans.⁹³ Properties with PACE-funded upgrades showed a default rate of about one tenth of one percent, compared with slightly over three percent of non-PACE homes in the area of the study prepared by PACENow.⁹⁴ Sonoma County, California is touted to dispel assertions about residential PACE loans increasing default and nonpayment risk,⁹⁵ as statistics depict a beneficial effect on mortgage default rates.⁹⁶ Sonoma County saw no

88. See *July 6 Statement*, *supra* note 12; WATT, *supra* note 18.

89. See Kaufman, *supra* note 87 (concluding that losses to foreclosing lenders are rare and would likely be small); see also Ian M. Larson, Law Summary, *Keeping PACE: Federal Mortgage Lenders Halt Local Clean Energy Programs*, 76 MO. L. REV. 599, 619 (2011) (“[N]one of the literature or argumentation by PACE critics has articulated an actualized harm to the industry: the entirety of the criticism has been based on what could occur, assuming that PACE boards fail to adopt or adhere to any of the recommended underwriting requirements. . . . PACE programs are unlikely to significantly impact lenders”). But see Todd Woody, *Loan Giants Threaten Energy-Efficiency Programs*, N.Y. TIMES, July 30, 2010, <http://www.nytimes.com/2010/07/01/business/energy-environment/01solar.html> (arguing that liens from PACE loans can cause substantial instability).

90. See generally 12 U.S.C. § 4511(a)–(b) (2012) (establishing the FHFA as a response to the economic crisis and empowering it to oversee federal mortgage buyers).

91. See Devashree Saha, *Enact Legislation Supporting Residential Property Assessed Clean Energy Financing (PACE)*, BROOKINGS INSTITUTE, REMAKING FEDERALISM / RENEWING THE ECONOMY 1 (Nov. 2012), <http://www.brookings.edu/~media/Research/Files/Papers/2012/11/13%20federalism/13%20housing%20energy%20efficiency.pdf>.

92. See Hoops, *supra* note 6, at 909.

93. See Kaufman, *supra* note 87 (arguing that data shows properties with PACE loans default less frequently than properties without them).

94. *Id.*

95. See, e.g., Larson, *supra* note 89, at 619 (analyzing data on Sonoma County and concluding that normal default rates would tend to cost mortgage lenders a mere \$150. Larson further emphasizes that “PACE-encumbered properties default at a rate sixty percent below the average default rate for that county.”).

96. PACENOW, *supra* note 89 (presenting data on default rates for PACE properties in Sonoma County, showing lower tax delinquency and no defaults on mortgages during the

mortgage defaults on properties encumbered by PACE liens between 2008 and PACENow's report in 2010.⁹⁷ Based on the existing data on defaults, lien priority issues are unlikely to burden the economy.

The low default rates observed in California residential PACE properties make a good case for the viability of the reserve fund system as a model for implementation of residential PACE in other states. The default rates suggest that a reserve fund would likely be called upon infrequently enough to mitigate concerns about exceeding a state's pool of funds, and suggest that a fairly modest reserve could wholly insulate federal mortgage lenders from the effects of PACE defaults.⁹⁸

C. Other States' Attempts to Restructure Lien Priority Dampen PACE Lending

Several states have addressed lien priority requirements by simply changing the lien priority structure to make PACE liens junior to mortgage liens.⁹⁹ This approach allocates foreclosure proceeds first to federal mortgage associations and lenders, and then uses any remaining funds to satisfy the PACE loans.¹⁰⁰ The foreclosure process is essentially the same for mortgage holders, and PACE liens do not introduce any additional risk.¹⁰¹ This approach has the advantage of clearly satisfying FHFA's residential PACE policy to the letter,¹⁰² whereas the California approach is subject to more scrutiny and requires approval from FHFA.¹⁰³ However, changing lien priority wholly changes PACE programs' structure, and undermines the advantages of PACE over other clean energy incentives.¹⁰⁴

survey period).

97. *Id.*

98. See Kaufman, *supra* note 87. But see Farrell, *supra* note 19 (arguing that the California reserve fund proposal was rejected because it was too small to cover potential demand. Farrell examines data from Sonoma County and determines that \$10 million would be used up too quickly and fail to satisfy the demand for PACE loans).

99. Friedrich, *supra* note 15 (stating that Vermont, Oklahoma, Maine, and Rhode Island allow residential PACE programs with junior liens).

100. See *New Approaches to Financing Energy Efficiency Investments*, CONSORTIUM FOR BUILDING ENERGY INNOVATION (Jan. 8, 2014), <http://research.cbei.psu.edu/research-digest-reports/property-assessed-clean-energy-pace-financing> (noting that subordinate PACE lien programs satisfy FHFA, but are less attractive to investors) [hereinafter CBEI]; see also LEFCOE, *supra* note 37, at 237–39 (describing lien priority on mortgaged properties).

101. See LEFCOE, *supra* note 37, at 237–39.

102. See *July 6 Statement*, *supra* note 12.

103. See WATT, *supra* note 18 (demonstrating that a reserve fund model will not be accepted at face value).

104. Letter from Moriarty, Director, Barclays Capital, to Jeffrey Tannenbaum, Fir Tree Partners (Sept. 14, 2009), available at http://pacenow.org/wp-content/uploads/2013/02/Pace-letter-sept-2009-re-liens-_2_-_2_-Barclays-9-14-09-_3_.pdf (concluding that making PACE liens subordinate to mortgage liens makes PACE financing bonds unattractive investments, and removes the ability to finance loans up front, effectively

Changing lien priority complicates post-foreclosure collection of outstanding PACE loan balances significantly, and would likely challenge the ability of municipal governments to effect enforcement.¹⁰⁵ Junior PACE liens would reduce the likelihood of the state recovering the outstanding loan balance,¹⁰⁶ and therefore reduces the state's incentive to stand as a lender.¹⁰⁷ Further, changing lien priority discourages PACE lenders, as they accept more risk and have to do more complicated underwriting, increasing the cost of transacting.¹⁰⁸

III. RESIDENTIAL PACE PROGRAMS MUST FACILITATE STABLE UNDERWRITING

FHFA's second major concern about residential PACE loans is that they change the way loans are underwritten, causing loans to be offered based on collateral rather than ability to pay with income.¹⁰⁹ This is particularly influential in the context of the housing bubble collapse, as instability in home values and ability to pay back mortgage loans defined the economic downturn.¹¹⁰ The California system offers solutions to this issue as well, taking a neutral position under which repayment is backed by the state,¹¹¹ making the loans more predictable than more speculative collateral-based loans.¹¹²

A. FHFA Concludes that Underwriting for PACE Loans is Unconventional and Destabilizing

FHFA states in its 2010 Decision that underwriting standards must be developed to reduce the risk to federal mortgage lenders to make residential PACE loans acceptable.¹¹³ Even in rejecting the \$10 million California

destroying the fundamental features and advantages of PACE) [hereinafter Letter from Moriarty].

105. *Id.*

106. *See* CBEI, *supra* note 100 ("Junior liens are less secure.").

107. *See* Suchman & Bloomfield, *supra* note 21 (explaining that lien priority encourages PACE lenders).

108. *See* Letter from Moriarty, *supra* note 104; *see also* JESSICA BAILEY, CLEAN ENERGY FINANCE AND INVESTMENT AUTHORITY, [http://www.dsireusa.org/incentives/incentive.cfm?](http://www.dsireusa.org/incentives/incentive.cfm?incentive_code=CT98F&re=0&ee=0)

[Incentive_Code=CT98F&re=0&ee=0](http://www.dsireusa.org/incentives/incentive.cfm?incentive_code=CT98F&re=0&ee=0) (discussing the economies of scale associated with PACE loans and concluding that small scale loans may not cover the cost of properly underwriting).

109. *July 6 Statement, supra* note 12.

110. *See* Lefcoe, *supra* note 37, at 181–84.

111. Letter from Edmund G. Brown, *supra* note 17.

112. *See* Cox, *supra* note 29, at 112 (stating that lending without sufficient assurance of repayment is "highly disfavored after the recent mortgage crisis.").

113. *July 6 Statement, supra* note 12.

proposal, FHFA has left the door open to novel workarounds, and suggests that the California reserve fund model could be viable despite concerns about its ability to cover senior liens.¹¹⁴ FHFA is concerned that underwriting practices for PACE loans are unconventional compared to ordinary loans, and PACE loans may challenge the underwriting of both PACE loans and mortgages.¹¹⁵ FHFA asserts that generally accepted standards and practices do not exist.¹¹⁶ This could lead to disparate valuations of similar loans and destabilize the primary and secondary mortgage markets.¹¹⁷ The basis for FHFA's concern is not convincingly established and can be refuted because there are existing national underwriting guidelines for energy efficient retrofits,¹¹⁸ and underwriting is done responsibly at the local level.¹¹⁹

B. California's Reserve Fund Model Will Establish Underwriting Guidelines and Pay the Difference in the Event of a Default

California addresses underwriting challenges by guaranteeing repayment

114. *Id.* (“FHFA remains committed to working with federal, state, and local government agencies to develop and implement energy retrofit lending programs with appropriate underwriting guidelines and consumer protection standards.”); *see also* WATT, *supra* note 18 (rejecting California's specific proposal but suggesting that a reserve fund that demonstrates its ongoing sustainability and ability to cover all potential losses could be viable).

115. *See* WATT, *supra* note 18; *see also* FHFA Notice of Proposed Rulemaking, *supra* note 80 (criticizing PACE loans for undermining indebtedness to value ratios, which are instrumental in underwriting mortgage default risk). *But see* Adam Browning, *Comments of Vote Solar Initiative on the Advanced Notice of Proposed Rulemaking and EIS Scoping Comments* 6, 6–7, available at www.fhfa.gov/webfiles/24471/115_Vote_Solar_Initiative.pdf (finding that clean energy upgrades increase property values, counteracting the negative underwriting consequences of additional debt. Browning states that mortgage default rates on PACE properties undermine the claim that PACE increases risk of “diminution in value or . . . default”).

116. *July 6 Statement*, *supra* note 12.

117. *See* Cox, *supra* note 29, at 110–14 (discussing the difficulty underwriting PACE loans and positing that the risk of foreclosing mortgage lenders having to pay off tax liens before receiving the security property could increase lending rates and undermine the value of secondary market products).

118. *See generally Guidelines for Pilot PACE Financing Programs*, U.S. DEP'T OF ENERGY (May 7, 2010), http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf (suggesting best practices for PACE programs to operate responsibly and minimize risk); *see also* Letter from Moriarty, *supra* note 104 (arguing that DOE's PACE underwriting guidelines have been widely followed and have helped PACE programs operate stably).

119. *See* Larson, *supra* note 89, at 620–22 (emphasizing that local PACE programs have been exceptionally successful at underwriting to avoid default, and arguing that some legislation has required more stringent underwriting standards than those suggested by the DOE); *see also infra* Section III (C) (discussing underwriting standards in further detail).

of shortfalls, which prevents faulty underwriting from harming mortgage holders.¹²⁰ If loans are irresponsibly granted based on collateral rather than ability to repay and foreclosure occurs, the mortgage lenders and secondary market buyers still receive the security property unencumbered.¹²¹ Perhaps more significantly, the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) sets regulations to include underwriting guidelines, and complying with the standards will be a prerequisite for participation.¹²²

One of the more compelling challenges to the underwriting of residential PACE loans is that clean energy technologies are not yet efficient enough to be cost-effective at the residential scale.¹²³ Some argue that clean energy upgrades the currently high but declining cost of clean energy technologies could make expensive upgrades worthless over time.¹²⁴ Such a scenario likely inflames FHFA's concerns about the ability to underwrite based on property assessment and the ability to recoup mortgage loans against senior liens in the event of foreclosure, since decreasing costs makes it difficult to estimate the upgrade's value over the life of a loan.¹²⁵ However, PACE programs following the California reserve fund model have several natural responses to these concerns. First, passing on the outstanding balance of retrofits to subsequent buyers can strengthen the borrowers' ability to repay.¹²⁶ Using a tax assessment rather than a loan based on repayment provides more stability to the borrower and likely helps borrowers stay solvent where interest rates rise, home values fall, or both.¹²⁷ Even where

120. See *July 6 Statement*, *supra* note 12 (proposing to hold funds in reserve to cover losses by federal entities); see also Boxer, *supra* note 62 (same). Secured lenders are then insulated from losses resulting from failure to evaluate ability to repay at the underwriting stage.

121. See Boxer, *supra* note 62 (explaining the reserve fund model as a response to nonpayment concerns).

122. Kaufman, *supra* note 84 (outlining the underwriting guideline development plan under California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA)).

123. See Joel B. Eisen, *Residential Renewable Energy: By Whom?* 31 UTAH ENVTL. L. REV. 339, 339–43 (2011).

124. See Cox, *supra* note 29, at 115.

125. *Id.*

126. NATURAL RES. DEF. COUNCIL ET AL., PROPERTY ASSESSED CLEAN ENERGY (“PACE”) PROGRAMS WHITE PAPER: HELPING ACHIEVE ENVIRONMENTAL SUSTAINABILITY AND ENERGY INDEPENDENCE, IMPROVING HOMEOWNER CASH FLOW AND CREDIT PROFILE, PROTECTING MORTGAGE LENDERS, AND CREATING JOBS 12 (2010) (contending that homeowners can get access to more cash which can be used to keep making mortgage payments, as PACE loans lower utility payments and require little or no upfront payments from the homeowner).

127. See *id.*, at 23–24; see also Suchman & Bloomfield, *supra* note 21 (stating that PACE loans do not accelerate upon default, which allows a homeowner to apply energy savings to mortgage payments).

property values fall, a home with a clean energy retrofit is likely to retain its comparative advantage against a similarly situated home.¹²⁸ Further, an upgrade purchased with current dollars passes on the benefit of future inflation since a tax assessment agreement is made at the time of the purchase.¹²⁹

C. The California Reserve Fund Model Insures Lenders Against Risk While Facilitating Appealing Localized Underwriting Standards

Some of the concerns over underwriting likely come from the variety of standards rather than the substance.¹³⁰ However, California's significant reserve fund allays FHFA's concerns particularly well as the shortfall coverage reduces risk and the retention of the traditional PACE lien structure provides more certainty for PACE loan underwriters.¹³¹ The senior lien structure supports the use of more localized and collateral-based underwriting standards,¹³² while the guarantee of the reserve fund still mitigates the risk associated with collateral-based underwriting standards.¹³³

The California model mitigates underwriting concerns by developing base underwriting standards at the state level but allows local authorities to use their expertise.¹³⁴ The municipalities are the only lenders, which makes them the most familiar with PACE programs, as well as local property values and other underwriting issues.¹³⁵ With a baseline of safe practices established at the state level and some room for local underwriting practices drawing on superior expertise, a municipality can offer stable underwriting that is more accurate for its own territory than could a broader set of criteria. Further, the state level baseline established by the California approach provides FHFA with a single point of contact with which it can discuss its concerns, and the state agency can pass down any necessary corrections or directives without FHFA having to deal with a patchwork of

128. See Larson, *supra* note 89 at 620 (explaining that PACE upgrades should not diminish lenders' returns, and only increase attractiveness of a property in the eyes of investors).

129. See Hoops, *supra* note 6, at 904–06.

130. See Larson, *supra* note 89 at 629.

131. Kaufman, *supra* note 84; see also Letter from Moriarty, *supra* note 104 (arguing that senior liens allow PACE lenders to make more favorable loans by absorbing less risk).

132. See Van Nostrand, *supra* note 4 (suggesting that lien priority lets PACE lenders make loans based more on individual security properties and the upgrades. Local underwriting can be more effective with specific knowledge).

133. Boxer, *supra* note 62 (stating that the reserve fund will insulate lenders from risk of failing to recover the full value in foreclosure). This simplifies underwriting by protecting lenders from the risk of errors.

134. See Suchman et al., *supra* note 34, at 1–2 (arguing that municipal PACE lenders are able to develop a level of expertise).

135. See *id.*

authorities.

Underwriting standards that vary geographically are likely less of a concern than lien priority given that the value of clean energy upgrades similarly varies.¹³⁶ For example, California's per-home rate of electricity consumption is significantly lower than the national average;¹³⁷ however, energy costs are higher than the national average, which brings the per-home energy spending in line with the national average despite the lower consumption rates.¹³⁸ Thus, California is an excellent site for early implementation of residential renewable energy systems. The potential for increasing home equity through clean energy upgrades is bolstered by the cost relative to traditional energy sources and the local climate.¹³⁹ PACE loans, specifically in the solar context, are likely more stable, and more aggressive underwriting techniques may not implicate FHFA's underwriting concerns in similar states.¹⁴⁰

IV. RECOMMENDATIONS FOR IMPLEMENTING AND IMPROVING THE FUND MODEL

States implementing the reserve fund model must consider adding provisions in PACE-enabling legislation that obligate the state to cover any losses exceeding set aside funds. FHFA states in the 2010 Decision that it "remains committed to working with federal, state, and local government agencies to develop and implement energy retrofit lending programs with appropriate underwriting guidelines and consumer protection standards."¹⁴¹ A guarantee tying those concerns in with the mechanism for insulating the secondary mortgage markets from risk would likely demonstrate that the state's system is tailored to meet the guidelines set forth in the 2010 Decision and characterize the system as congruent with federal policy.¹⁴² Some programs currently use reserve fund systems, for example, Vermont's PACE program.¹⁴³ These programs, however, may

136. U.S. ENERGY INFO. ADMIN., HOUSEHOLD ENERGY USE IN CALIFORNIA (2013), http://www.eia.gov/consumption/residential/reports/2009/state_briefs/pdf/ca.pdf.

137. *Id.* (reporting that California's per-home energy consumption is approximately thirty one percent lower than the national average, which the United States Energy Information Agency (USEIA) attributes largely to low heating and cooling needs due to mild climate).

138. *Id.*

139. *See id.*

140. *July 6 Statement, supra* note 12.

141. *Id.*

142. *See id.*; *see also* WATT, *supra* note 18 (resting rejection of the \$10 million California proposal primarily on its failure to demonstrate the ability to fully insulate federal lenders from losses).

143. Sija Qiu & Jocelyn Durkay, *Pace Financing*, NATIONAL CONFERENCE OF STATE LEGISLATORS, Oct. 22, 2014, *available at* <http://www.ncsl.org/research/energy/pace->

not keep lien priority,¹⁴⁴ so tax assessments do not transfer with the property.¹⁴⁵ States should enact legislation preserving PACE lien priority to provide the benefits of PACE,¹⁴⁶ but must structure the reserve fund to fully insulate federal mortgage lenders.

Given the May 2014 rejection of California's \$10 million proposal, it is essential that a reserve fund model like California's get funding at least directly matching any possible losses, and demonstrate its ability to maintain that funding on an ongoing basis.¹⁴⁷ A state may address the loss coverage concerns by extensively studying the numbers and establishing a reserve fund significantly exceeding the expected need. Residential PACE programs may be able to satisfy FHFA's underwriting and ongoing sustainability concerns by following the model of some municipalities and requiring a positive cash flow,¹⁴⁸ where the value of energy savings from PACE retrofits exceeds the monthly repayment of the loan.¹⁴⁹ This feature can help strengthen the reserve fund model by reducing the risk of drawing on the reserve fund. If a positive cash flow can be maintained, then PACE loan repayments will not draw funds away from repayment of a mortgage, and loan to value ratios calculated by the mortgage lender will remain generally unaffected.

The positive cash flow approach has been used successfully in Leon County, Florida's Leon Energy Assistance Program (LEAP).¹⁵⁰ Florida's PACE-enabling legislation mandates that loans pay for themselves and cannot pull funds away from mortgage payments.¹⁵¹ This is one of the best ways to avoid both underwriting and lien priority problems. Other states should add Florida's statutory language¹⁵² to the California reserve fund model, and guarantee approval for energy efficiency and clean energy retrofits that can demonstrate net savings through an audit. However, the

financing.aspx.

144. See *id.* (stating that Vermont downgraded its program to a junior lien).

145. See Hoops, *supra* note 6, at 906 (explaining that the use of tax assessments means obligation transfers upon transfer of the property).

146. See Letter from Moriarty, *supra* note 104 (advocating senior priority for PACE liens).

147. See WATT, *supra* note 18 (emphasizing full loss coverage and sustainability as the two necessary elements of an acceptable residential PACE program).

148. See *generally* Underwriting Standards Executive Summary, *supra* note 80, at III (B)(1)(b) (summarizing the discussion of cash-flow effects in comments supporting residential PACE).

149. Suchman et al., *supra* note 34, at 1.

150. Underwriting Standards Executive Summary, *supra* note 80, at III (B)(1)(b).

151. See FLA. STAT. §163.08(12)(b) (West 2013) (approving PACE loans when an audit "demonstrates that the annual energy savings from the qualified improvement equals or exceeds the annual repayment amount.").

152. *Id.*

positive cash-flow requirement could close the door to more ambitious upgrades, like clean energy generation systems, that states should use PACE to push implementation of these technologies. In addition to guaranteed approval for positive cash-flow upgrades, states should add provisions to allow PACE loans for clean energy systems if: an audit does not show that the PACE loan will cause the borrower to default on mortgage payments; the entirety of the payment is not being made from home equity credit;¹⁵³ and the borrower's mortgage does not prohibit it.

To prevent FHFA from challenging the risk associated with senior lien structures under a reserve fund system, PACE-enabling legislation should be explicit about matching reserved funds to outstanding PACE loan balances on federally backed mortgages. Ideally, the agencies tasked with administering the program should maintain a schedule of set-aside funds for the full value of a PACE loan at issue, releasing the set-aside funds for other loans as the outstanding loan balance is reduced. Because FHFA prohibits senior loans for residential PACE if they introduce risk of recovery for foreclosing mortgage holders,¹⁵⁴ expressly demonstrating the lack of risk to the federal mortgage associations is essential to winning FHFA approval.

States should similarly require disclaimers explaining the risks involved with lien priority issues, as FHFA has expressed particular concern over protecting consumers from making uninformed decisions.¹⁵⁵ For example, the HERO Program administrators met with FHFA and developed language to warn potential PACE borrowers about the repayment requirements and possible effects on mortgages.¹⁵⁶

In the Background section of its Request for Comments on the Proposed Rule,¹⁵⁷ FHFA remarks that some PACE programs do not require recording PACE loans, describing the role of recording in stable underwriting.¹⁵⁸ It would be shrewd for a residential PACE program to require recording to give lenders and creditors adequate notice of

153. See, e.g., *Interested in moving forward with PACE? Follow these five steps.*, EFFICIENCY VERMONT, <http://www.encyvermont.com/For-My-Home/Financing/Financing/The-PACE-Process> (last visited Apr. 3, 2015) (stating that Vermont PACE programs allow a loan-to-value ratio for PACE assessment of ninety percent, and a debt-to-income ratio of forty one percent). Vermont provides a model for allowable ratios, but states implementing a strong reserve fund could allow slightly higher ratios, as the reserve fund will cover losses, and higher limits will allow more homeowners to access clean energy upgrades. *Id.*

154. See generally *July 6 Statement*, *supra* note 12; WATT, *supra* note 18.

155. See *July 6 Statement*, *supra* note 12 (discussing consumer protection concerns).

156. See Friedrich, *supra* note 15 (describing the success of HERO's approach to notifying consumers to prevent risky borrowing or loans that violate mortgage terms).

157. See generally FHFA Underwriting Standards Executive Summary, *supra* note 80.

158. See *id.* at II (C) (discussing recording as a method of strengthening underwriting, by notifying future creditors about possible subordinating liens and ensuring that homeowners do not take loans that violate the terms of their mortgage).

homeowners' obligations. While this might increase transaction costs, it would help ease underwriting concerns, and similarly address the problem of PACE loans violating the terms of some mortgages.¹⁵⁹ States implementing residential PACE programs should make this a requirement, as it would help protect underwriters from making loans to people without the ability to repay outside of home equity credit. It would further notify potential borrowers that they may need approval from their mortgage lender, which would protect against mortgage borrowers increasing their ratio of indebtedness to property value after the mortgage lender made a bargain premised on the existing ratio.

In order for PACE to succeed in the residential context, it is critical for loans and assessments to be made inexpensively.¹⁶⁰ Transaction costs associated with PACE loans create economy of scale considerations; smaller scale upgrades may fail to create enough equity to exceed the costs associated with the transaction.¹⁶¹ PACE programs emulating the California reserve fund model would be wise to keep sight of that fact and write any milestones significant to the economic viability of a project into its underwriting guidelines. PACE enabling legislation should set size requirements for PACE programs to ensure that each PACE lender has enough potential borrowers to benefit from economies of scale.¹⁶²

Where municipalities are too small to provide enough potential borrowers, the legislation should call for the administrative overseer to approve regional programs or opt-ins to larger programs in adjacent areas. Such a requirement would concentrate more data and expertise in each PACE program, which could strengthen underwriting. Using private lenders would likely drive up the cost of transacting because each lender would have to underwrite and collect with less understanding of the market and less access to data.¹⁶³ State and local agencies would have to monitor

159. *Id.*; see also LEFCOE *supra* note 37 at 389–94 (discussing how tax liens can violate the rights of mortgagees). Tax liens can violate covenants against actions that could impair the security property, or can trigger the doctrine of waste. This may force lenders to raise their rates, and may increase costs by increasing time spent on research. Additionally, recording often requires hiring professionals who may charge several hundred dollars. *Id.*

160. See, e.g., Jessica Bailey, *Connecticut Local Option – Commercial PACE Financing*, CLEAN ENERGY FINANCE AND INVESTMENT AUTHORITY, http://www.dsireusa.org/incentives/incentive.cfm?Incentive_Code=CT98F&re=0&ce=0 (stating that transaction costs challenge the value of small loans).

161. *Id.* (asserting that upgrades financed by PACE loans are likely not worth the cost of transacting in the commercial context if the upgrade project is less than \$150,000).

162. See WHITE HOUSE, POLICY FRAMEWORK FOR PACE FINANCING PROGRAMS 1 (2009), available at http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf (“[E]conomies of scale from making PACE financing available to a large group of borrowers can reduce overhead and transaction costs.”).

163. See generally Suchman et al., *supra* note 34, at 1–2.

more entities, making it more expensive for the governments. Similarly, the use of junior lien priority forces the underwriters to account for more risk, and would increase transaction costs further.¹⁶⁴ Structuring PACE programs to reduce transaction costs is essential to the viability PACE loans.

CONCLUSION

Widespread implementation of clean and renewable energy sources is continually rising on the list of national priorities.¹⁶⁵ Programs like PACE are essential to meeting the nation's energy aspirations, as evidenced by the fact that the implementation of clean energy technologies in the residential context has largely followed state incentives.¹⁶⁶

As discussed in this Comment, PACE has succeeded because of its structural features. New programs looking for best practices should emulate the California model, which, when strengthened by the suggestions proposed in this Comment, is the most viable system that preserves those structural features while complying with FHFA's 2010 Decision to suspend senior lien residential PACE. The use of tax assessments as the mechanism for paying back loans gradually allows access to financing for upgrades that undoubtedly increase the equity of houses. However, offering these loans on the basis of future savings and resulting equity opens these loans up to people who would not otherwise be able to afford the high up-front cost of clean energy retrofits. The lien structure of the California model differentiates it from other state approaches; though it does invite scrutiny from FHFA, the California model can avoid FHFA's concerns and benefit borrowers, lenders, cities and states as no other model can. The maintenance of a significant reserve fund is a strong way to prove to FHFA that senior liens for PACE loans can exist without inviting risk to the mortgage markets.

The efforts that some states have made to implement residential PACE in the wake of the 2010 Statement are unconvincing and have drawn criticisms. The California system represents a different way of thinking about the problem. One of the biggest barriers is underwriting, and states can control underwriting through legislation to assure FHFA that mortgage lenders' standards are not varying or unstable. If other states adopt

164. *Id.*

165. See Hoops, *supra* note 6, at 907 (describing recent endorsement of PACE by federal agencies and demand-driven expansion of PACE programs).

166. See U.S. ENERGY INFO. ADMIN., ANNUAL ENERGY OUTLOOK 2014 (2014), http://www.eia.gov/forecasts/aeo/MT_residentialdemand.cfm#taxcredits (predicting that the rate of residential implementation of renewable energy sources will correlate with availability of public funding based on existing data).

standards similar or identical to California's, then the transaction costs of PACE loans can be kept down and it will help make the system more viable.

States and localities looking to implement a residential PACE program should model their programs after California's, which addresses FHFA's concerns, but retains the classic PACE structure and keeps the focus of the program on clean energy. With few federal requirements relating to residential clean energy standards, such as underwriting guidelines, the boundaries of administrative authority over the issue is relatively undefined. FHFA is a new agency, and seems concerned more with finance than with the energy efficiency and green building goals of PACE programs. Both FHFA and state governments have the potential to significantly affect the future of clean energy and green building by getting into the forefront of the issue. If more states adopt a secure residential PACE model that still allows for the positive features of the typical PACE system like the California reserve fund system, it may provide enough assurances to FHFA to compel the Agency to reopen residential PACE.

California is a natural leader on the issue, as it has by far the greatest experience with implementation of solar energy systems in residential settings, accounting for some eighty two percent of national installed capacity in 2010.¹⁶⁷ According to the United States Energy Information Agency (USEIA), residential homes account for twenty one percent of the country's energy use.¹⁶⁸ In comparison, commercial electricity consumption comprises about eighteen percent.¹⁶⁹ Residential PACE is thus a natural entry point for spreading clean energy technologies.

Renewable energy sources currently constitute approximately twelve percent of total energy generation in the United States.¹⁷⁰ The high costs of renewable energy sources have restricted their growth relative to traditional sources like fossil fuels.¹⁷¹ To achieve the United States' energy goals, it is essential to emulate best practices and implement successful clean energy programs like PACE at the lowest cost. The California reserve fund model provides the best of PACE and, with a few extra assurances, provides the

167. U.S. ENERGY INFO. ADMIN., PHOTOVOLTAIC (PV) COST AND PERFORMANCE CHARACTERISTICS FOR RESIDENTIAL AND COMMERCIAL APPLICATIONS, FINAL REPORT 11, 14–15 Prepared for Office of Integrated Analysis and Forecasting (2010), available at <http://www.eia.gov/analysis/studies/distribgen/system/pdf/appendix-a.pdf>.

168. The USEIA additionally reports that in 2012, the transportation and industrial sectors were the largest sectors of total national energy consumption, accounting for twenty eight percent and thirty two percent, respectively. U.S. ENERGY INFO. ADMIN., USE OF ENERGY IN THE UNITED STATES EXPLAINED (2013) http://www.eia.gov/energyexplained/index.cfm?page=us_energy_use

169. *Id.*

170. RENEWABLE ENERGY INCENTIVES, *supra* note 166.

171. *Id.*

best hope for residential clean energy at this time.