DRIVING GROWTH AND MITIGATING RISK:

STANDARDS FOR RESIDENTIAL PACE PROGRAMS

INSIGHT BRIEF

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HIGHLIGHTS

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- Industry leaders, in collaboration with local governments, have **developed a set of standardized consumer protections for property assessed clean energy (PACE) programs** that go above and beyond state legislative requirements and are recommended for universal adoption by state and local governments and bond-issuing entities.
- These consumer protection standards can **position residential PACE financing for rapid growth while mitigating risk** for consumers and lenders.
- **Continued program standardization and coordination is needed** to enable PACE financing to gain traction nationally.

INTRODUCTION

PACE (property assessed clean energy) is a new and innovative solution for financing energy-efficiency and renewable energy projects. The approach is successfully overcoming many of the barriers that result in homeowner underinvestment in clean energy measures. As the PACE market grows (to more than 100,000 homes in California, its birthplace), local governments that authorize PACE financing and the private companies that typically provide PACE financing are focused intently on protecting the interests of consumers, who most often learn about PACE from an energy-service contractor.

Residential PACE programs are poised to scale in communities in a number of new states, including Missouri and Florida. As more state and local governments consider adopting PACE programs, and more PACE finance providers enter the market, it is vitally important that all market participants operate with the highest degree of integrity, lending standards, underwriting criteria, business conduct, and consumer protections—designed to eliminate bad outcomes for homeowners, mortgage lenders, and the local communities that they serve.

Several actors in the residential PACE sector have come together to create a set of consumer protection standards to guide the industry forward as it scales. This insight brief discusses the benefits that a standardized slate of consumer protections can offer the market while improving overall outcomes for local governments, homeowners, and lenders. This paper briefly explains the impetus for creating the consumer protection standards and describes the process for their development. It then outlines a set of risks that consumer protection standards serve to mitigate. It is our belief that continued development of standards and baselines for PACE program design will serve to enhance the scaling and liquidity of resources available for this market.

THE CHALLENGE

One overarching barrier has complicated the expansion of residential PACE financing programs nationally. In July 2010, after PACE legislation was enacted in over half the states, the Federal Housing Finance Agency (FHFA) prohibited mortgage giants Fannie Mae and Freddie Mac from buying mortgages of properties with a PACE assessment. FHFA's opposition to PACE resulted in almost half of the mortgage market being blocked to PACE transfers,[i] one of the key program advantages that removes barriers to investments in systems like solar panels. The FHFA's opposition to PACE created a ripple effect throughout the market, leading most policymakers and state governments to suspend or abandon plans to establish residential PACE programs.

THE SOLUTION

The U.S. Department of Housing and Urban Development's Federal Housing Administration (HUD/FHA) and the Department of Veterans Affairs (VA) created guidance on critical design elements for residential PACE programs, including options for transferring PACE assessments with FHA- and VA-backed mortgage products. This first comprehensive federal endorsement of PACE recognizes the power that PACE has to help homeowners make energy-efficient choices for their properties.

Going one step further, public, private, and nonprofit PACE stakeholders have developed a comprehensive set of consumer protection policies that track and often exceed the requirements of the federal guidance. The aim of PACE industry leaders is to provide homeowners and local governments with a baseline of consistent consumer protections. PACENation—a nonprofit with more than 300 member organizations, including nearly all PACE stakeholders throughout the U.S.—is encouraging industry-wide adoption of these standards. This effort to create a consumer protection foundation is required for rapid PACE program operationalization and growth.

POISED FOR GROWTH

Residential PACE financing was created in 2008 in Berkeley, California, as part of a program to promote solar photovoltaic installations.[ii] Large upfront capital costs had long been a barrier to greater adoption of renewable energy resources, with payback periods of 10 to 20 years that far exceed the 5 to 7 years that people typically own a particular home. Unfortunately, the utility costs associated with owning a home have not historically been captured in housing prices, and consequently, markets have not recognized the value of distributed energy resources. The City of Berkeley's key insight that lead to PACE was to adapt the assessment financing tool used for decades by local governments throughout the nation to finance improvements like sidewalks, parks, and water and sewer projects that benefit homeowners and meet a public purpose. A program was structured to create a special property assessment, attached to a single home, that could be paid off over the course of 20 years as part of the home's property tax bill. Just as the solar panels would stay attached to the home, the logic was that the obligation would as well, and if the home were sold, the new owners would assume payments and continue to enjoy the benefits of the lower utility bill.

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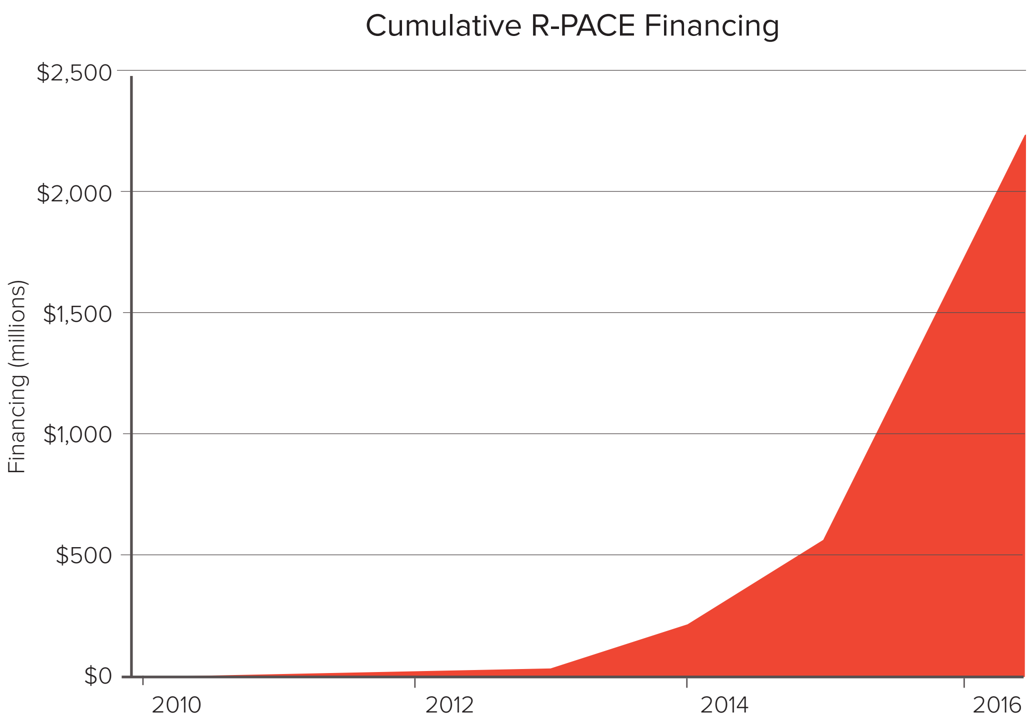
[i] Payoff of a financing upon sale would be typical for other forms of financing, but is in no other instance required for a local government assessment. The FHFA's stance regarding payoff of PACE assessments is, therefore, extraordinary.
[ii] While PACE is a financing tool for both residential (i.e., 1–4 unit buildings) and nonresidential buildings, this paper focuses exclusively on residential PACE, or R-PACE.

Berkeley's pilot of 13 homes totaling some $336,550 has since evolved into an emerging national movement. Today more than 100,000 homes have used PACE to fund over $2.2 billion in energy improvements, predominantly in California (see "PACE in California" for more background). From 2010 through 2015, residential PACE saw an average annual growth rate of roughly 675 percent.[iii] Figure 1 shows the cumulative amount of residential PACE upgrades underwritten from 2010 to today.

Figure 1: Cumulative R-PACE Financing, 2010–2016



Source: PACENation

PACE IN CALIFORNIA

Although California Governor Brown's PACE Loss Reserve Program was created with the intention of allaying the concerns of the FHFA, the FHFA still has not embraced it as a solution. Nonetheless, its creation gave local governments and other public entities (like the statewide Joint Powers Authority that sponsors the CaliforniaFIRST program) added peace of mind—and the implicit backing of the governor—to be able to allow PACE programs to operate in their communities. The Loss Reserve Fund has never been tapped.

[iii] Derived from data listed on PACENation's market data platform: http://pacenation.us/pace-market-data/

In August 2015, President Obama directed HUD and FHA to develop guidance for allowing PACE assessments on homes with FHA-backed mortgages. This past July, the FHA released that guidance, which recognizes the fundamental validity of PACE as a local government assessment, allows PACE programs to offer PACE financing, and authorizes FHA lender banks to extend mortgages to homes with an existing PACE assessment. It is hoped that the FHA's embrace of PACE financing will encourage broader adoption of PACE by state and local governments. Furthermore, other parts of the U.S. experienced the same positive results as California, and the resulting data can help address the concerns of the FHFA, Fannie Mae, and Freddie Mac.[iv]

THE UTILITY OF PACE

Despite FHFA's continuing objections to PACE, a handful of PACE programs remained active and even expanded in California,[v] generating the impressive numbers cited above. California's success, the absence of direct challenges from the FHFA, and the recent guideline announcements by FHA and VA are encouraging other state and local governments beyond California to start their own residential programs. Strong federal agency support from HUD/FHA, the VA, and the Department of Energy (DOE) for PACE has reduced concerns, and positive results in California clearly show the ability PACE has to help achieve important public policy goals. As proven in California, PACE spurs private investment in a broad range of clean energy projects that help make homes more comfortable, more valuable, and less expensive to operate. Local officials recognize that these investments create local clean-energy jobs and increase local spending, while also helping local governments achieve their climate action plan goals.

For consumers, PACE financing is an attractive solution because it provides streamlined access to relatively low-cost, long-term financing based on the value of their home rather than their personal credit. While PACE may not always be the "cheapest" form of financing, it provides a unique alternative. For example, many home equity lines of credit (HELOCs) can be secured at a lower cost than PACE, but less than 12 percent of homeowners have a HELOC in place. Home equity loan interest rates are a little bit less than or on par with PACE interest rates, but it takes time to get approved for one, and some consumers can't get approved or can't get competitive rates. The most competitive rates for unsecured loans are on par with PACE, but their longest repayment terms are typically seven to ten years max. PACE's longer repayment terms—up to the lifespan of what's being financed—allows for lower monthly/annual payments. Most importantly PACE creates an obligation that may be able to transfer at sale with the property, as opposed to HELOCs and home equity loans that have to be repaid by the property owner at the point of sale.

Since PACE does not require any upfront payments, it can also be a good option for homeowners when a system fails, or if they would like to improve a system's energy efficiency

[iv] For example, an analysis of the sales prices for over 800 HERO Program PACE-assessed homes that have sold since being upgraded showed that those PACE-upgraded homes, taking into account their assessments, sold for higher prices than standard housing indices would have predicted, and for higher prices than similar non-PACE homes. See Laurie Goodman and Jun Zhu's study at: http://www.iijournals.com/doi/abs/10.3905/jsf.2016.21.4.006

[v] Sonoma County started its program in 2008 with a focus on climate change mitigation, and was spurred on to continue by local contractors despite the rejection of PACE by FHFA. The HERO program, started in Riverside County, helped create jobs during the housing industry meltdown when construction employment was struck particularly hard there. The CaliforniaFIRST program launched in the summer of 2014 after Governor Brown put in place the PACE Loss Reserve Program. The program was created precisely to remove the financial risk perceived by FHFA and the mortgage industry around PACE.

but do not have cash on hand. PACE program administrators cite major system breakdowns as the main catalyst that leads homeowners to explore the overall energy performance of their homes. As is the case with all property taxes and other assessments, PACE assessments are linked to the home and may be able to transfer to a new owner upon sale of the home, along with the benefits of the PACE-funded improvements.

THE ROAD TO A SET OF CONSUMER PROTECTION STANDARDS

PACE projects are a substantial commitment for homeowners. It is therefore incumbent on all parties to a PACE-funded project to adhere to the highest standards of consumer protections (and business best practices) to ensure the best outcomes, because PACE impacts local governments that sponsor programs, homeowners, and, in most cases, an existing mortgage lender. Recognizing this, the DOE issued its Guidelines for Pilot PACE Financing Programs in 2010. These served as the basis for early best practices established by PACENation (then operating as PACENow) in 2014. The experience of leading PACE providers in California, however, made it clear that more extensive consumer protections were necessary. Even before the August 2015 announcement promising HUD/FHA guidance, several program administrators had already begun to develop and implement comprehensive consumer protection policies.[vi]

Renovate America and Renew Financial—program administrators for, respectively, the Western Riverside Council of Governments (WRCOG) and the California Statewide Communities Development Authority (CSCDA), joint power authorities that aggregate local governments that want to offer PACE in California—developed consumer protections that have been embraced by all WRCOG and CSCDA PACE providers. After surveying other PACE stakeholders, PACENation released a version of these policies, Consumer Protection Policies Version 1.0, that now serve as an industry standard. The goal of these policies is to promote a baseline of consumer protections that PACENation recommends for adoption as a minimum standard by all state and local governments, or the public entities sponsoring a multi-jurisdictional PACE program. PACE, as a public-private partnership, requires stronger consumer protections than other financing options. PACENation's standards provide clear expectations to public partners and service providers, while providing homeowners with the highest level of protection.

EXPANDING THE RESIDENTIAL PACE MARKET WHILE MITIGATING RISK

Consistent consumer protection standards upheld across local communities and states will help ensure the successful growth and scaling of residential PACE programs, while protecting the integrity of PACE as a public-private partnership.

PACE program administrators are hopeful that consumer protection policies and other program design requirements will not vary much from state to state and from local government to local government. Standardization of operations across jurisdictional boundaries will reduce the need for customization and enable consistency, which will allow PACE programs to continue to streamline their operations, and thus provide lower costs to participating homeowners.

PACE is unique among financing programs in that local governments have the authority to

[vi] In 2014, PACENow, Renovate America, Renew Financial, Ygrene, and others convened to develop a set of best practices. Similarly, municipalities such as Sonoma, San Francisco, Placer, and Los Angeles worked separately on developing a set of consumer protection policies.

direct a PACE program that is operating in its jurisdiction to cease operating at any time. The threat of a program being rescinded in a community provides extra incentive to PACE providers to furnish extensive customer support and disclosures. In fact, as in keeping with the PACENation-recommended consumer protections, leading PACE providers continue their relationship with borrowers to help them manage real estate transactions, including refinancing and selling their properties. Local government partners know that they have case management services available at an individual homeowner level. No other form of financing offers that level of post-funding consumer care.

With the recent issuance of FHA guidance, just released updated DOE best practice guidelines for programs, and approaching PACE stakeholder convergence on a universal set of consumer protection standards,[vii] residential PACE is on a trajectory for rapid expansion through continued standardization. Although 32 states have adopted PACE-enabling legislation, only 50 percent of these have active programs, which are predominantly commercial. This leaves the opportunity for all states developing or improving residential PACE programs to immediately satisfy large lending institutions' program requests (FHA Guidelines) while ensuring the highest levels of consumer protection. Consumer protection standards can also enable capital providers to more quickly and affordably provide liquidity to these new markets, by serving to mitigate commonly perceived risks around PACE financing. The table below outlines a set of perceived risks around PACE and how they can be managed through consumer protection policies.

[vii] The DOE issued a draft set of "Best Practice Guidelines for Residential PACE Financing Programs" alongside the FHA's guidelines announcement on July 19, 2016. Following the DOE's guidelines release, DOE requested public comments on these best practices, which contain a section on consumer protections. It is our hope and expectation that DOE and PACE industry stakeholders will align on a shared set of consumer protection standards.

Table 1: Risks and Mitigation Strategies Inherent in Consumer Protection Standards

RISK	MITIGATION
Homeowner will not be able to afford the annual PACE assessment payment	• Only high-performing products that deliver utility bill savings and help pay for financing are eligible for installation. • Mortgage and property tax payment history are reviewed in underwriting. • Recent bankruptcy history is reviewed in underwriting. • Repayment terms extend to the lifespan of products or a maximum 25 years, lowering monthly/annual payments to less than 65% of other financing options.
Homeowner will become over-leveraged	• Pre-PACE combined loan-to-value ratio (CLTV) must be less than 90%. • Post-PACE CLTV must not exceed 100%. • Annual total property tax bill must not exceed 5% of the property's fair market value.
PACE assessment will reduce sale price	• Empirical data show that properties with PACE assessments command a price premium, taking both the PACE-financed assets and liabilities into account.
Mortgage holder will lose out in foreclosure	• Only the current amount due/in arrears of the PACE assessment must be paid at foreclosure, with remaining payment obligations transferring to the new owner; the full balance does not accelerate upon foreclosure. • PACE programs may offer a subordination option in states with senior lien statutes.
Homeowners will commit to a PACE contract without a clear understanding of the financing terms	• Consumer protections require a financing statement/summary that is modeled after the federal Consumer Finance Protection Bureau's "Know Before You Owe" (KBYO) form, which is now required in the mortgage industry. • Comprehensive disclosures provide for a three-day right to cancel, prepayment options, and the risk that the homeowner may need to pay off the PACE assessment at time of sale or refinancing.
Senior citizens will commit to a PACE contract without full understanding of the obligation	• Program develops and implements a protocol for homeowners who are 65 years old and older to confirm their full understanding of the PACE assessment contract, including a confirmed terms call.
Unqualified contractors will perform the work	• Program requires review of contractor qualifications, credit, customer reviews, and insurance coverages.
Unscrupulous contractors will prey on unsuspecting homeowners	• Contractors must adhere to program rules and standards or face suspension or termination. • PACE providers may escalate to law enforcement and take legal action.
Contractor will get paid and leave before work is completed	• Program does not pay contractor in full until the work is completed to the homeowner's satisfaction.
Contractor will install product not rated as efficient	• Program must verify individual product details from a database or list it maintains.
Contractor will over-charge	• Program establishes and enforces cost caps on all measures.
Bad contractors continue in the program	• Program establishes a disciplinary process that can include probation or expulsion of contractors from the program. • Program manages, tracks, and resolves inquiries and complaints from homeowners.
PACE program does not adhere to the Consumer Protections	• Program submits itself to an independent audit of business practices related to the Consumer Protections Policies.

For the latest version of the PACENation Consumer Protection Policies summarized in part above, please visit www.pacenation.us/consumer-protection-policies.

CONCLUSION

In summary, we applaud the efforts of PACE industry stakeholders in developing robust program guidelines and independent audit processes, and support the industry's goal for these guidelines to be the standard across state and local governments. Given that PACE must be enabled at a state level and then municipal level, any elements of program design that can further streamline and standardize program operationalization will deepen the ability for PACE to continue to scale nationally. PACE districts and local governments wishing to bring PACE to their communities can adopt the PACENation policies as their baseline standards, requiring that program administrators meet or exceed these guidelines.

It is apparent given states' and localities' enthusiasm to adopt PACE that PACE serves to address a significant market gap. Now with FHA and VA loans available for PACE-encumbered properties, as well as take-out products such as the Fannie Mae HomeStyle Energy Loan,[viii] little stands in the way of residential PACE's rapid scaling.

ABOUT ROCKY MOUNTAIN INSTITUTE
Rocky Mountain Institute (RMI)—an independent nonprofit founded in 1982—transforms global energy use to create a clean, prosperous, and secure low-carbon future. It engages businesses, communities, institutions, and entrepreneurs to accelerate the adoption of market-based solutions that cost-effectively shift from fossil fuels to efficiency and renewables. In 2014, RMI merged with Carbon War Room (CWR), whose business-led market interventions advance a low-carbon economy. The combined organization has offices in Basalt and Boulder, Colorado; New York City; Washington, D.C.; and Beijing.

[viii] Fannie Mae's HomeStyle Energy Loan can be used for primary or secondary mortgages and to conduct home energy improvements or to pay off an existing PACE encumbrance on a home. This product therefore enables homebuyers to enter into a "conforming" mortgage, which meets FHFA requirements and therefore is eligible for purchase by Fannie Mae and Freddie Mac in the secondary market.