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Via Electronic and U.S. Mail

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street, S.W.
Washington, D.C. 20024
(Comments/RIN 2590-AA53)

RE: **Comments of the California Attorney General on the Federal Housing Finance Agency's Advance Notice of Proposed Rulemaking re Property Assessed Clean Energy (RIN 2590-AA53)**

Dear Mr. Pollard:

We write this letter concerning the Advance Notice of Proposed Rulemaking addressing whether and under what conditions the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (collectively, the "Enterprises") will purchase mortgages for properties participating in Property Assessed Clean Energy ("PACE") programs.[1] 77 Fed. Reg. 3958 (Jan. 26, 2012). As you are aware, state PACE laws allow local governments to finance renewable energy systems and energy and water efficiency retrofits for their residents using their longstanding assessment powers. Since Fannie Mae and Freddie Mac own or guarantee approximately half of all residential mortgages, the direction that the Federal Housing Finance Agency ("Agency") gives the Enterprises by this rule will largely determine the fate of residential PACE programs in California and across the nation.

The Agency is undertaking the current rulemaking as required by a preliminary injunction issued in the California PACE litigation, to which the California Attorney General is a

[1] The Attorney General submits these comments pursuant to her independent authority under the State Constitution, common law, and statutes to represent the public interest. These comments are made on behalf of the Attorney General and not on behalf of any other agency or office.

party.[2] The court's order is designed to remedy the Agency's failure to follow the Administrative Procedure Act in issuing its July 6, 2010 PACE directive ("Directive"), which prohibited any Enterprise accommodation of PACE programs. In the Advance Notice, the Agency proposes to continue to "direct the Enterprises not to purchase *any* mortgage that is subject to a first-lien PACE obligation or that could become subject to first-lien PACE obligations without the consent of the mortgage holder." 77 Fed. Reg. at 3963 (emphasis added).[3]

We urge the Agency to follow the requirements of the APA and its own statute, the Safety and Soundness Act (12 U.S.C. § 4501 *et seq.*) in devising its PACE rule. As discussed below, these requirements obligate the Agency affirmatively to seek out evidence about the potential risks and benefits of PACE, focusing, in particular, on data from operating PACE programs; consider alternatives to flatly prohibiting Fannie Mae and Freddie Mac from purchasing any mortgages for properties participating in PACE; and account for the larger public interest that will be served by accommodating PACE.

BACKGROUND TO THE RULEMAKING

CALIFORNIA'S PACE LAW AND BENEFITS OF PACE

California has been a pioneer in creating financing programs for renewable power systems, and energy and water efficiency retrofits for homeowners. These programs, commonly called PACE programs, reduce energy and water use, provide clean power, and are part of California's efforts to promote clean energy and green jobs. In California, state PACE law[4] authorizes local governments to use their traditional assessment power to finance renewable energy and energy and water efficiency improvements on private property. PACE programs do not operate using loans in a traditional sense. Instead, under PACE, local governments finance the upfront installation costs, and homeowners repay those costs over a period of years through assessments that appear on the property tax bill. The obligation to pay passes to any successive owner. Under longstanding California law, assessments create liens that have priority over mortgages.

In passing AB 811, the California Legislature expressly found that PACE would help to address the issue of global climate change by making energy and water efficiency improvements affordable for consumers. It found:

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[2] *People of the State of California v. Federal Housing Finance Agency,* No. C 10-03084 CW/LB (N.D. Cal., filed July 14, 2010) and consolidated cases. The Agency currently is appealing the preliminary injunction, obtained by Sonoma County, that requires this rulemaking.

[3] In California and in most states with PACE laws, PACE assessments have lien priority, meaning that they are paid before any private mortgage, in the same manner as all other taxes and assessments.

[4] California Assembly Bill 811 (Cal. Stats. 2008, ch. 159), Cal. Streets & Hwys. Code § 5898.12.

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

Cal. Streets & Hwys. Code § 5898.14.

The benefits of PACE extend beyond those found by the California Legislature. A recent study commissioned by the advocacy group PACENow confirms that PACE, if allowed to proceed, would also contribute substantially to the green economy:

> After modeling PACE implementation in the four communities [Santa Barbara, San Antonio, Columbus, and Long Island, N.Y.], the study team found that $4 million in total PACE spending across the four cities would generate $10 million in gross economic output, $1 million in combined federal, state, and local tax revenue, and 60 jobs. Extrapolating from this study, if 1 percent of the 75 million owner-occupied homes were to invest in an average of $20,000 PACE project each, the economic impact would translate into $15 billion in gross economic output, $4 billion in combined federal, state, and local tax revenue, and 226,000 jobs.[5]

FEDERAL SUPPORT FOR PACE PROGRAMS

The White House highlighted PACE in its "Recovery Through Retrofit" initiative in October 2009. In the accompanying report,[6] the White House noted the benefits of PACE:

> Property tax or municipal energy financing allows the costs of retrofits to be added to a homeowner's property tax bill, with monthly payments generally lower than utility bill savings. This arrangement attaches the costs of the energy retrofit to the property, not the

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[5] See the summary of the PACENow report by the Brookings Institution at http://www.brookings.edu/opinions/2011/0830_clean_energy_muro_saha.aspx.
[6] Available at www.whitehouse.gov/administration/eop/ceq/initiatives/retrofit.

> individual, eliminating uncertainty about recovering the cost of improvements if the property is sold.

The White House further stated that "Federal Departments and Agencies will work in partnership with state and local governments to establish standardized underwriting criteria and safeguards to protect consumers and minimize financial risks to the homeowners and mortgage lenders." On October 18, 2009, the White House released its "Policy Framework for PACE Financing Programs," announcing support "for the use of federal funds for pilot programs of PACE financing to overcome barriers for families who wish to invest in energy efficiency and renewable energy improvements."[7]

Through the American Recovery and Reinvestment Act's Energy Efficiency and Conservation Block Grant Program, the Department of Energy ("DOE") expressly identified PACE as eligible for receipt of hundreds of millions of dollars in federal stimulus funds. In early 2010, a number of local governments across California were poised to launch their own PACE programs, supported in part by federal dollars administered through the California Energy Commission. By February 2010, the California Energy Commission already had awarded tens of millions of dollars in Recovery Act State Energy Program funding to support California PACE programs. DOE also spearheaded an effort to develop "best practices guidelines" for PACE programs in its "Guidelines for Pilot PACE Financing Programs."[8]

THE AGENCY'S ACTIONS TO PAUSE PACE PROGRAMS

On July 6, 2010, the Agency unexpectedly issued a "Statement on Certain Energy Retrofit Loan Programs" stating the Agency's intent to "pause" PACE programs.[9] The Agency's July 2010 Directive contains three elements. First, the Agency makes several summary and general assertions about the risks purportedly posed by PACE, none of which are supported by data or analysis. For example, the Agency asserts that: "First liens established by PACE loans are unlike routine tax assessments and pose unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors"; PACE programs "present significant risk to lenders and secondary market entities, may alter valuations for mortgage-backed securities and are not essential for successful programs to spur energy conservation" and "disrupt a fragile housing finance market and long-standing lending priorities"; and "the absence of robust underwriting standards to protect homeowners and the lack of energy retrofit standards to assist homeowners, appraisers, inspectors and lenders determine the value of retrofit products combine to raise safety and soundness concerns." Second, the Agency states that "programs with first liens run contrary to the Fannie Mae-Freddie Mac Uniform Security Instrument." Lastly, the Agency directs Fannie Mae, Freddie Mac, and, in addition, the Federal Home Loan Banks, to

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[7] Available at www.whitehouse.gov/assets/documents/PACE_principles.pdf.
[8] Available at http://www1.eere.energy.gov/wip/pdfs/arra_guidelines_for_pilot_pace_programs.pdf.
[9] Available at http://www.fhfa.gov/webfiles/15963/PACE_ststament_7_14_10.pdf.

undertake what it calls "prudential actions." These include, for example, "[e]nsuring that loan covenants require approval/consent for any PACE loan."

In response to the Agency's July 2010 Directive, DOE publicly announced that "prudent management of the Recovery Act compels DOE and Recovery Act grantees to consider alternatives to programs in which the PACE assessment is given a senior lien priority." The California Energy Commission then cancelled its previous State Energy Program/Recovery Act awards intended to support PACE programs. Millions of dollars of federal Recovery Act funds that would have gone to support California PACE programs were awarded for other purposes.

In response to the Agency's Directive, the State of California and a number of cities and counties and public interest organizations filed suit in federal court challenging the Agency's anti-PACE actions. By order dated August 26, 2011, the federal district court denied the Agency's motion to dismiss California's claims under the Administrative Procedure Act ("APA") and the National Environmental Policy Act ("NEPA"), and, in addition, granted Sonoma County's motion for preliminary injunction. The Court's order requires the agency promptly to begin a PACE rulemaking proceeding. The Agency is appealing the ruling, but the Ninth Circuit Court of Appeals has refused to stay the Advanced Notice of Proposed Rule pending appeal.

COMMENTS

Under section 706(2)(A) of the APA, a reviewing court must, "hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2). An agency's decision is arbitrary and capricious, "if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.* ("*State Farm*"), 463 U.S. 29, 43 (1983).

In order to satisfy the APA, an "agency must explain the *evidence* which is available, and must offer a 'rational connection between the *facts* found and the choice made.'" *Id.* (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962) (emphasis added)). As the Supreme Court noted, "[g]enerally, one aspect of that explanation would be a justification for [taking action] before engaging in a search for further evidence." *Id.* at 52. Under this standard, the Agency cannot, as it has to date, simply rely on unsupported assumptions and conclusory assertions that PACE poses financial risks to the Enterprises. Rather, the Agency has an obligation to seek out evidence about the potential financial risks (*e.g.*, the actual mortgage default rates for PACE participants as compared to non-participants, and, in the case of defaults for PACE participants, the dollar amount of any PACE assessments paid before the mortgage) and, in addition, the financial benefits of PACE to the Enterprises (which include reduced energy bills for homeowners that may actually reduce the default rate, and any increase in home value after PACE improvements). The Agency should give special attention to data from operating

PACE programs. We believe that the experiences of PACE leaders (including Sonoma County and the City of Palm Desert) will demonstrate that well-designed PACE programs do not result in the hypothetical risks to the Enterprises asserted by the Agency.

In addition, the APA requires the Agency to consider alternatives to flatly prohibiting Fannie Mae and Freddie Mac from purchasing any mortgages for properties participating in PACE. While an agency has considerable discretion to exercise its expert judgment, an agency does not have discretion to ignore apparently reasonable courses of action without offering an explanation and engaging in analysis. *See State Farm,* 463 U.S. at 46, 48 (holding that before National Highway Transportation Safety Administration could rescind passive restraint standards because of problems with automatic seatbelts, agency was required to give consideration to less drastic option of modifying standard to require airbag technology); *see also Muckleshoot Indian Tribe v. U.S. Forest Service*, 177 F.3d 800, 813-14 (9th Cir. 1999) (holding that agency's failure to consider adequate range of alternatives in environmental impact statement violates NEPA).[10]

As noted above, pursuant to the rule of *State Farm*, 463 U.S. at 37-38, if the Agency determines that PACE poses risks to the safety and soundness of the Enterprises, it must evaluate whether those risks could be addressed by actions short of a complete prohibition on Fannie Mae and Freddie Mac purchasing mortgages for properties participating in PACE. The July 2010 Directive itself indicates that asserted risk could be reduced by imposition of "robust underwriting standards to protect homeowners" and "energy retrofit standards to assist homeowners, appraisers, inspectors and lenders determine the value of retrofit products." Moreover, in considering how PACE might be accommodated, the Agency has an obligation to consider, for example, the PACE "best practices" formulated by the U.S. Department of Energy in its "Guidelines for Pilot PACE Financing Programs" published May 7, 2010,[11] and those set forth in the pending PACE legislation, H.R. 2599, 112th Cong. (2011) (referred to the S. Comm. on Insurance, Housing and Community Opportunity on Aug. 22, 2011), known as "The PACE Assessment Protection Act of 2011."[12] Failure to consider such options would constitute a violation of the APA. *See State Farm*, 463 U.S. at 48. To the extent the Agency believes that resources do not address all of the Agency's concerns, the Agency must determine whether or how they might be improved. Finally, if the Agency finds that substantial data gaps exist even with the data from operating programs, the Agency must analyze whether certain established or federally funded PACE programs should be allowed to proceed as "pilot" programs for the purposes of gathering additional information about the real-world risks of PACE.

Finally, the Safety and Soundness Act does not allow the Agency to flatly prohibit PACE simply because, in some limited instances, as with other assessments, a mortgage holder will be

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[10] The Notice states that the Agency will prepare an Environmental Impact Statement, as it must under the National Environmental Policy Act.
[11] *See* footnote 8, above.
[12] Available at http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.182&filename=h2599ih.pdf&directory=/diska/wais/data/112_cong_bills.

required to pay an outstanding PACE assessment before a mortgage.[13] The Agency's supervisory and regulatory responsibilities under the Safety and Soundness Act are not limited to ensuring that Fannie Mae and Freddie Mac and their shareholders and executives are guaranteed substantial and maximum profit. As stated in 12 U.S.C. section 4513(a)(1)(B)(v), one of the "principal duties of the Director" is to "ensure that … the activities of each regulated entity and the manner in which such regulated entity is operated are *consistent with the public interest*." (Emphasis added). In the case of PACE, the public interest favors working with the states to accommodate their PACE laws and respecting the long-standing power of local governments to tax and assess. In addition, the public interest is advanced by allowing PACE programs to proceed in order to obtain the benefits of energy efficiency, consumer savings, pollution reduction, and green jobs and industries. The Agency must consider these benefits in determining whether the accommodation of PACE by Fannie Mae and Freddie Mac, with or without additional restrictions or conditions, is in the public interest.

CONCLUSION

We appreciate the opportunity to comment on the Agency's Advanced Notice of Proposed Rulemaking. We respectfully request that the Agency give PACE the full and objective consideration that the law requires.

Sincerely,

/s/
JANILL RICHARDS
Supervising Deputy Attorney General

For KAMALA D. HARRIS
Attorney General

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[13] As the Agency is aware, in the event of a default, only unpaid PACE assessments, not the entire amount financed, is paid before the mortgage. The obligation to pay remaining assessments as they become due passes to the new property owner on sale, as with other assessments.