Department of Energy
Washington, DC 20585

March 26, 2012

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Mr. Pollard,

The U.S. Department of Energy has prepared the enclosed comments for your attention regarding the Advanced Notice of Proposed Rulemaking on Mortgage Assets Affected by PACE (RIN 2590-AA53).

Improving residential energy efficiency is an important strategic energy policy objective for the nation. Inefficient housing stock imposes a major financial burden on homeowners and, since residential buildings consume more than 20% of US energy, they impose a significant burden on the environment. Overall, a 10% improvement in energy performance in the residential sector would save more than $20 billion each year, and would result in economic, environmental, and energy security benefits.

In its January 26, 2012 Advanced Notice of Proposed Rulemaking, FHFA raises many questions about the potential risk of PACE to national residential mortgage markets. Because there is insufficient data and analysis available to provide conclusive answers, DOE seeks FHFA cooperation to facilitate work with government-sponsored entities in the housing sector that would inform answers with appropriate data analysis.

DOE has an interest in working with FHFA on developing solutions for investments in residential energy efficiency that are compatible with a stable and strong housing market in America. DOE strongly urges FHFA to partner with relevant stakeholders, including DOE, to ensure that pilot PACE programs are implemented with appropriate safeguards as outlined in the DOE *Guidelines for Pilot PACE Financing Programs.*

DOE appreciates the opportunity to engage FHFA on the important matter of improving the energy performance of housing in America, and we hope that FHFA will take these views into consideration in preparation of the rule.

Sincerely,

Jonathan N. Elkind
David Sandalow for DBS
Assistant Secretary for
Policy & International Affairs

Henry Kelly
Acting Assistant Secretary for
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Comments on the FHFA Advanced Notice of Proposed Rulemaking on Mortgage Assets Affected by PACE Programs

Prepared by U.S. Department of Energy
March 26, 2012

Overview:

Improving residential energy efficiency is an important strategic energy policy objective for the nation. Inefficient housing stock imposes a major financial burdon on homeowners and, since residential buildings consume more than 20% of US energy, they impose a significant burden on the environment. Overall, a 10% improvement in energy performance in the residential sector would save more than $20 billion each year[1], and would result in economic, environmental, and energy security benefits.

In its January 26, 2012 Advanced Notice of Proposed Rulemaking, FHFA raises many questions about the potential risk of PACE to national residential mortgage markets. The concerns FHFA expresses generally fall into three categories:

1. The potential impact of PACE on residential property values.
2. The potential impact of PACE on residential mortgage default rates.
3. The potential impact of PACE defaults on mortgage holder value.

Because there is insufficient data and analysis available to provide conclusive answers, DOE seeks FHFA cooperation to facilitate work with government-sponsored entities in the housing sector that would inform answers with appropriate data analysis.

DOE has an interest in working with FHFA on developing solutions for investments in residential energy efficiency that are compatible with a stable and strong housing market in America. DOE strongly urges FHFA to partner with relevant stakeholders, including DOE, to ensure that pilot PACE programs are implemented with appropriate safeguards as outlined in the DOE *Guidelines for Pilot PACE Financing Programs.*

DOE is offering points of information based on extensive engagement in the development of residential energy efficiency programs.

- DOE works with thousands of Local Community Agencies on residential energy efficiency upgrades for low-income homeowners through the Weatherization Assistance Program.
- Through the Better Buildings Neighborhood Initiative, DOE is working with dozens of local and state governments pursuing innovative models for financing investment in residential energy efficiency beyond low-income households.
- DOE developed *Guidelines for Pilot PACE Financing Programs* in May 2010 to support local governments seeking to apply PACE to the residential sector. These

[1] EIA Annual Energy Review 2011, Table 3.6.

Guidelines were developed with insight and feedback from local government officials, energy investors, mortgage investors, and the independent financial regulators.

- DOE is currently consulting with local governments on implementation of PACE programs for commercial properties.

PACE is a property assessment program, distinct from a loan program.

- PACE programs enable energy efficiency and renewable energy improvements to be financed through property assessments that are determined by state law to have a valid public purpose.
- Property assessments are transferable from one homeowner to the next over many years, allowing owners to make long term investments even if they expect to own the house for a shorter period.
- PACE programs offer critical factors likely to lead to greater success than other potential energy efficiency financing options, including lower costs of capital, longer terms that align energy savings with assessment repayment, and transferability at time of sale.

Property tax assessments have not been identified as a source of financial risk to mortgage lenders.

- Property tax assessment programs administered by local governments are common in the United States, and none have been identified as posing systemic risk to the home mortgage market.

PACE assessments for energy efficiency improvements relieve a property of excess operating costs, reducing rather than increasing the cost of ownership.

- Under the *DOE Guidelines for Pilot PACE Financing Programs* , homeowners may only access a PACE program if the projected energy savings equal or exceed the payments for the assessment, thus improving the homeowner's cash flow.
- PACE provides a mechanism through which individual homeowners can reduce the financial burden of poor energy performance and rising energy prices on the cost of ownership.

There are contrasting views on the relationship between the financial performance of residential mortgages and the energy performance of residential properties.

- FHFA has raised concern that implementation of PACE programs would increase financial risk to mortgage lenders.
- FHFA proposes to mitigate any potential risk to the performance of home mortgages by taking actions that would effectively prevent any local or state government from proceeding with a PACE program.

- By contrast, energy inefficient houses impose on household budgets higher operating costs as well as more exposure to energy price volatility and rising prices over time. Reducing energy costs may reduce the risk of default on mortgages for those homes.
- This risk to the performance of mortgages for energy inefficient houses could be mitigated with a capital investment in energy performance improvements that yields average annual savings greater than fixed payments for assessments.

Data and analysis are needed in order to understand the effect of PACE programs on the performance of residential mortgages.

- For researchers outside the government-sponsored entities for housing and their contractors, mortgage data is difficult to access due to concerns about the confidential or proprietary nature of address-specific information.
- Insufficient data and analysis is available to validate a view that implementation of PACE programs would increase financial risk to mortgage lenders or that it would decrease financial risk to mortgage lenders.
- Drawing on sufficiently large data samples, study of both existing data as well as deliberate and controlled pilots would help test the logic underpinning either view.
- Three components are relevant to examine in order to evaluate any risk to the home mortgage market posed by PACE programs: (a) impairment to mortgages in the event of a default, (b) effect on the valuation of properties with PACE assessments, (c) likelihood of default.
- DOE is willing to work with FHFA on ways to approach the gathering and analysis of data from PACE programs, examining the three components of risk identified above among other aspects of interest.

The FHFA's Advisories and subsequent statements would discourage state and local governments from attempting residential PACE programs.

- The various documents issued by FHFA instruct regulated entities not to secure mortgages with PACE assessments, and the documents instruct them to tighten underwriting standards for all properties in a PACE district, regardless of whether those properties are participating in a PACE program.
- Due to the dominant role of the federally regulated entities in the mortgage securities market, the FHFA documents already issued, taken together, have effectively ended the development of PACE programs. Of the dozens of residential PACE programs in development in 2010, virtually all have been idled.
- In the absence of any PACE programs, there will remain insufficient data to perform the analysis necessary to examine and address concerns raised by FHFA.

Pilot projects would generate data for analysis without posing significant financial risk to mortgage lenders.

- Pilot PACE programs can be implemented with standards based on the *DOE Guidelines for Pilot PACE Financing Programs* (enclosed).
- Recognizing the importance of stability in home mortgage markets, the *Guidelines for Pilot PACE Financing Programs* provide protection to government-sponsored enterprises for housing as well as the secondary markets they support.

DOE would like to work with FHFA to examine the effect of home energy performance on mortgage performance.

- DOE seeks FHFA cooperation through instruction to its regulated entities to facilitate analysis of existing mortgage data in a way that protects private data.
- With instructions to an established third party for mortgage data analysis, Fannie Mae and Freddie Mac can provide or permit access to anonymized loan underwriting and servicing data for the purpose of evaluating the loan performance of energy efficient homes.

PACE is an innovative approach to addressing market barriers that have challenged other financing approaches to residential energy efficiency, and appropriate next steps toward its development should proceed.

- DOE strongly urges FHFA to partner with relevant stakeholders, including DOE, to ensure that pilot PACE programs are implemented with appropriate safeguards as outlined in the DOE *Guidelines for Pilot PACE Financing Programs.*
- The next step in understanding both the risk posed by energy waste in homes, and the most effective means for mitigating the risk, would be to conduct pilot PACE programs, tightly governed by the *Guidelines for Pilot PACE Financing Programs*.
- The number and scale of pilot PACE programs would need to yield a sample size of assessments sufficiently large to overcome concerns expressed about the validity of studies performed on small sample surveys. The necessary data can be collected for further analysis through the pilots, and the *Guidelines* can be reviewed and revised over time in collaboration with FHFA and stakeholders.

Department of Energy
Washington, DC 20585

Guidelines for Pilot PACE Financing Programs

May 7, 2010

This document provides best practice guidelines to help implement the Policy Framework for PACE Financing Programs announced on October 18, 2009.[1] Property Assessed Clean Energy (PACE) financing programs allow state and local governments, where permitted by state law, to extend the use of land-secured financing districts to fund energy efficiency and renewable energy improvements on private property.[2] PACE programs attach the obligation to repay the cost of improvements to the property, not to the individual borrower. After consultation within the federal government and with other stakeholders, the Department of Energy has prepared the following Best Practices to help ensure prudent financing practices during the current pilot PACE programs.

These best practice guidelines are significantly more rigorous than the underwriting standards currently applied to land-secured financing districts. Especially in light of the exceptionally challenging economic environment and recovering housing market, the following best practice guidelines for pilot PACE financing programs are important to provide an extra layer of protection to both participants who voluntarily opt into PACE programs, and to lenders who hold mortgages on properties with PACE tax liens. These best practice guidelines may evolve over time as we learn more about the performance of PACE programs and are able to identify new best practices.[3] All pilot PACE financing programs are strongly encouraged to follow these best practice guidelines. This document is divided into two sections: Program Design Best Practice Guidelines and Assessment Underwriting Best Practice Guidelines.

[1] The Policy Framework for PACE Financing Programs is available here: http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf.
[2] For more information on PACE programs, please visit: http://www1.eere.energy.gov/wip/solutioncenter/financialproducts/PACE.html. PACE programs are paid through a tax lien on the property. Lien priority is a matter of state law, and these best practices do not (and cannot) pre-empt state law.
[3] These best practice guidelines are primarily for the residential market. Different standards may be appropriate in non-residential markets.

Program Design Best Practice Guidelines:

Local governments should consider the following program design features to increase the reliability of energy and economic performance for the benefit of program participants, mortgage holders, and investors.

1. Expected Savings-to-Investment Ratio (SIR) Greater Than One[4]

The primary rationale for PACE programs is to pursue a legally-defined "public purpose", which generally includes environmental, health, and energy independence benefits.[5] Although traditional land-secured assessment districts do not require projects to "pay for themselves", PACE financing should generally be limited to cost effective measures to protect both participants and mortgage holders until PACE program impacts become more widely understood.

The financed package of energy improvements should be designed to pay for itself over the life of the assessment. This program attribute improves the participant's debt-to-income ratio, increasing the participant's ability to repay PACE assessments and other debt, such as mortgage payments. Local governments should consider three program design features to ensure that the expected SIR is greater than one:[6]

- An energy audit and modeling of expected savings to identify energy efficiency and renewable energy property improvement measures that are likely to deliver energy and dollar savings in excess of financed costs over the assessment term. Local governments should limit investment to those identified measures.

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[4] SIR = [Estimated savings over the life of the assessment, discounted back to present value using an appropriate discount rate] divided by [Amount financed through PACE assessment]

Savings are defined as the positive impacts of the energy improvements on participant cash flow. Savings can include reduced utility bills as well as any payments for renewable energy credits or other quantifiable environmental and health benefits that can be monetized. Savings should be calculated on an annual basis with an escalator for energy prices based either on the Energy Information Agency (EIA) U.S. forecast or a substantiated local energy price escalator.

[5] Specific public purposes are defined by the state's enabling legislation, which may vary somewhat between states. Existing legislation is available here: http://www.dsireusa.org/incentives/index.cfm?EE=1&RE=1&SPV=0&ST=0&searchtype=PTFAuth&sh=1

[6] These program options are not mutually exclusive and programs should consider deploying them in concert. In addition, these measures could be coordinated with the proposed HOMESTAR's Silver and Gold guidelines. More Information on HOMESTAR is available here: http://www.whitehouse.gov/the-press-office/fact-sheet-homestar-energy-efficiency-retrofit-program

- In lieu of audits, programs may choose to limit eligibility to those measures with well-documented energy and dollar savings for a given climate zone. There are a number of energy efficiency and renewable energy investments that are most likely to yield a SIR of greater than one for most properties in a region.
- Encourage energy efficiency before renewable energy improvements. The economics of renewable energy investments can be enhanced when packaged with energy efficiency measures. The SIR should be calculated for the entire package of investments, not individual measures.

2. The Term of the Assessment Should Not Exceed the Useful Life of the Improvements

This best practice guidelines document is intended to ensure that a property owner's ability to repay is enhanced throughout the life of the PACE assessment by the energy savings derived from the improvements. It is important to note that the useful life of the measure often exceeds the assessment term.

3. Mortgage Holder of Record Should Receive Notice When PACE Liens Are Placed

Mortgage holders should receive notice when residential property owners fund improvements using a PACE assessment.[7]

4. PACE Lien Non-Acceleration Upon Property Owner Default

In states where non-acceleration of the lien is standard for other special assessments, it should also be standard for PACE assessments. After a foreclosure, the successor owners are responsible for future assessment payments. Non-acceleration is an important mortgage holder protection because liability for the assessment in foreclosure is limited to any amount in arrears at the time; the total outstanding assessed amount is not due in full.

5. The Assessment Should Be Appropriately Sized

PACE assessments should generally not exceed 10% of a property's estimated value (i.e. a property value-to-lien ratio of 10:1). In addition, because of the administrative requirements of administering PACE programs, assessments should generally not be issued for projects below a minimum cost threshold of approximately $2500. These measures ensure that improvements are "right-sized" for properties and for the administrative costs of piloting PACE programs. PACE programs may also choose to set the maximum assessment relative to median home values.

[7] A different standard may apply to non-residential properties.

6. Quality Assurance and Anti-Fraud Measures

Quality assurance and anti-fraud measures are essential protections for property owners, mortgage holders, investors, and local governments. These measures should include:

- Only validly licensed auditors and contractors that adhere to PACE program terms and conditions should be permitted to conduct PACE energy audits and retrofits. Where feasible or necessary, auditors and contractors should have additional certifications appropriate to the installed measures.
- Inspections should be completed on at least a portion of participating properties upon project completion to ensure that contractors participating in the PACE program are adequately performing work.
- If work is not satisfactorily completed, contractor payment should be withheld until remedied. If not satisfactorily remedied, programs should disqualify contractors from further PACE-related work.
- Property owners should sign-off before payment is issued for the work.

7. Rebates and Tax Credits

The total amount of PACE financing should be net of any expected direct cash rebates for the energy efficiency or renewable energy improvements chosen. However, other non-direct cash incentives can be more difficult to manage. For example, calculating an expected income tax credit can be complicated, as not all participants will have access to the tax credit and there will be time lags between project completion and tax credit monetization. Programs should therefore consider alternative structures for financing this gap, including assignment of rebates and tax credits to repay PACE assessments, short-term assessment additions, and partnering with third party lenders that offer short-term bridge financing. At the minimum, programs should provide full disclosure to participants on the implications and options available for monetizing an income tax credit.

8. Participant Education

PACE may be an unfamiliar financing mechanism to program participants. As such, it is essential that programs educate potential participants on how the PACE model works, whether it is a property owner's most appropriate financing mechanism, and the opportunities and risks PACE program participation creates for property owners. Programs should clearly explain and provide disclosures of the following:

- How PACE financing works

- Basic information on other financing options available to property owners for financing energy efficiency and renewable energy investments, and how PACE compares
- All program fees and how participants will pay for them
- Effective interest rate including all program fees, consistent with the Good Faith Estimate (GFE) of the Real Estate Settlement Procedure Act (RESPA) and the early and final disclosure of the Truth in Lending Act (TILA).
- PACE assessment impact on escrow payments (if applicable)
- Risk that assessment default may trigger foreclosure and property loss
- Information on transferring the assessment at time of sale
- Options for and implications of including tax credits in the financed amount

9. Debt Service Reserve Fund

For those PACE programs that seek third party investors, including investors in a municipal bond to fund the program, an assessment reserve fund should be created to protect investors from late payment or non-payment of PACE assessments.

10. Data Collection

Pilot programs should collect the data necessary to evaluate the efficacy of PACE programs. Examples of typically collected data would include: installed measures, investment amount, default and foreclosure data, expected savings, and actual energy use before and after measures installation. To the extent possible, it's important that programs have access to participant utility bills, ideally for 18 months before and after the improvements are made. The Department of Energy will provide more detailed information on collecting this data, obtaining permission to access utility bills, and how to report program information to enable a national PACE performance evaluation.

Assessment Underwriting Best Practices Guidelines:

Local governments should design underwriting criteria to reduce the risk of default and impairment to the property's mortgage holders. Many best practices for reducing these risks are included in the previous section. In addition, underwriting criteria for individual assessments should include the following:

1. Property Ownership

- Check that applicant has clear title to property and that the property is located in the financing district.

- Check the property title for restrictions such as details about power of attorney, easements, or subordination agreements.

2. Property-Based Debt and Property Valuation

- Estimated property value should be in excess of property owner's public and private debt on the property, including mortgages, home equity lines of credit (HELOCs), and the addition of the PACE assessment, to ensure that property owners have sufficient equity to support the PACE assessment. Local governments should be cautious about piloting the PACE model in areas with large numbers of "underwater" mortgages.
- To avoid placing an additional tax lien on properties that are in distress, have recently been in distress, or are at risk for distress, the following should be verified:
    - There are no outstanding taxes or involuntary liens on the property in excess of $1000 (i.e. liens placed on property for failure of the owner to comply with a payment obligation).

      Property is not in foreclosure and there have been no recent mortgage or other property-related debt defaults.
- Programs should attain estimated property value by reviewing assessed value. This is typically used in assessment districts. If assessed value appears low or high, programs should review comparable market data to determine the most appropriate valuation. If programs believe the estimated value remains inaccurate or there is a lack sufficient comparable market data to conduct an analysis, they should conduct a desktop appraisal.[8]

3. Property Owner Ability to Pay

PACE programs attach the obligation to repay the cost of improvements to the property (not to the individual borrower). The standard underwriting for other special assessments only consists of examining assessed value to public debt, the total tax rate, and the property tax delinquency rate. However, we deem certain precautions important due to the current vulnerability of mortgage lenders and of the housing market in many regions. These precautions include:

- A Savings-to-Investment Ratio (SIR) greater than one, as described above, to maintain or improve the property owner's debt-to-income ratio.
- Property owner is current on property taxes and has not been late more than once in the past 3 years, or since the purchase of the house if less than three years.[9]

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[8] A desktop appraisal involves a licensed appraiser estimating the value of a property without a visual inspection. These appraisals cost approximately $100.

[9] Applicants that have purchased the property within 3 years have recently undergone rigorous credit analyses that compensate for the short property tax payment history.

- Property owner has not filed for or declared bankruptcy for 7 years.

These best practice guidelines will evolve over time with continued monitoring of the performance of pilot PACE financing programs.