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ISSUES WITH PROPERTY ASSESSED CLEAN ENERGY PROGRAMS

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You asked for (1) a summary of the Federal Housing Finance Agency's (FHFA) objections to property assessed clean energy (PACE) programs, such as those authorized in Connecticut by PA 11-80, and its actions in this area; (2) a description of responses by other states in the wake of FHFA's actions; and (3) legislative options for Connecticut in response to the federal actions.

SUMMARY

PACE programs allow municipalities and counties to provide loans for energy efficiency and renewable energy improvements. The loans are backed by an assessment on the improved property. The assessment is enforced by a lien, which in most states, although not Connecticut, has priority over existing mortgages.

FHFA has jurisdiction over the residential secondary mortgage market, where mortgages are packaged into securities and are bought and sold by investors. It regulates the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which dominate this market.

FHFA has raised three concerns regarding PACE programs. First, it believes that the priority liens established by PACE programs may alter valuations for mortgage-backed securities and pose significant risk to lenders and other entities in the secondary market. Second, FHFA

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believes that PACE loans lack adequate consumer protections. Third, it believes that the programs lack robust underwriting standards to protect homeowners and have inadequate energy retrofit standards.

In August 2010, Fannie Mae and Freddie Mac announced that they would not purchase mortgages originated on or after July 6, 2010 that were secured by properties encumbered by PACE obligations. In February, 2011, FHFA's general counsel sent a letter to general counsel for Fannie Mae and Freddie Mac, reaffirming that debts arising from PACE programs pose significant risks to these entities. FHFA directed that Fannie Mae and Freddie Mac continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations. In effect, FHFA's actions precluded mortgages with PACE liens from being sold on the secondary market and stopped the implementation of PACE programs with regard to residential properties in Connecticut and elsewhere.

In response to the federal actions, California, Sonoma County, and several other jurisdictions sued FHFA, Fannie Mae, and Freddie Mac, seeking declaratory and injunctive relief. They argued, among other things, that the federal entities violated the requirements of the Administrative Procedures Act (APA) and the National Environmental Protection Act (NEPA). The court denied FHFA's motion to dismiss, allowing the suit to proceed. It granted, in part, Sonoma County's motion for a preliminary injunction. It ordered FHFA, without withdrawing its directives to Fannie Mae and Freddie Mac, to proceed with the notice and comment process required by law *California v. Federal Housing Finance Agency. et al,* N.D. California, 8/26/2011, 2011 WL 3794942. The comment period is underway. Similar litigation is pending in Florida. In addition, legislation is before Congress that would require FHFA to rescind its directives regarding PACE loans that met specified criteria.

Michigan and Vermont have adopted legislation to address FHFA's concerns. In 2010, Michigan authorized municipalities to establish a loan program to provide financing for clean energy (energy efficiency and renewable energy project) improvements, but only for commercial and industrial property owners. Michigan's legislation requires that PACE assessments for property owners with outstanding mortgages receive written consent from mortgage holders.

Vermont passed legislation in 2011 that limits its PACE law to residential properties, makes PACE liens subordinate to existing liens and all first mortgages, and establishes two tiers of reserve funding to provide security for PACE assessments. After this legislation was adopted, FHFA sent a letter to the agency responsible for PACE in

Vermont in which it stated that it supported the overall approach of the legislation, although the letter made recommendations regarding its implementation.

Connecticut does not give PACE liens priority over existing mortgages, which has been FHFA's largest concern about PACE programs. It is not clear to what extent Connecticut's law addresses FHFA's other concerns. The state has at least four options for responding to the actions of FHFA, Fannie Mae, and Freddie Mac. It could (1) wait and see what happens following the FHFA comment period, the resolution of the pending litigation, and any action taken by Congress; (2) seek guidance from FHFA on the extent to which Connecticut's law fails to comply with its policies; (3) limit Connecticut PACE programs to commercial and other properties where FHFA does not have jurisdiction; or (4) amend PA 11-80 to emulate Vermont's law, which FHFA has commented on favorably.

INTRODUCTION

Connecticut and 23 other states have passed legislation authorizing municipalities or counties to establish PACE programs. Under these programs, the municipality or county provides loans for energy efficiency and renewable energy improvements to properties in their jurisdictions. The loans are backed by an assessment on the properties that participate in the program. The property is subject to a lien, which in most states, although not Connecticut, has priority over existing mortgages and other liens on the property. In Connecticut, existing mortgages have priority over the PACE lien. OLR report 2011-R-0326 provides additional information about the PACE provisions in PA 11-80. Further information about PACE in other states is available at: http://www.dsireusa.org/incentives/index.cfm?EE=1&RE=1&SPV=0&ST=0&searchtype=PTFAuth&sh=1.

The federal Housing and Economic Recovery Act of 2008 created FHFA from a variety of housing finance agencies. It gave FHFA regulatory jurisdiction over Fannie Mae (the Federal National Mortgage Association), Freddie Mac (the Federal Home Loan Mortgage Corporation), and the 12 federal home loan banks, and thus over the secondary residential mortgage market. In September 2008, in the midst of the housing crisis, FHFA took Fannie Mae and Freddie Mac into conservatorship.

FHFA ACTIONS

On June 18, 2009, FHFA sent a letter to banking and creditor trade groups and associations of mortgage regulators, governors, and state legislators, asserting that PACE programs posed risks to homeowners and lenders. On September 18, 2009, Fannie Mae issued a "lender letter" to the mortgage sellers and servicers it deals with in response to FHFA's questions about PACE programs, providing a link to FHFA's letter.

On May 5, 2010, Fannie Mae and Freddie Mac issued letters to their mortgage sellers and servicers, again addressing concerns about PACE programs. It asked the sellers and servicers to (1) learn whether there were existing or prospective PACE programs in jurisdictions where they do business and (2) be aware that programs with first liens run contrary to the Uniform Security Instrument used by Fannie Mae and Freddie Mac, which prohibits new senior liens except for taxes. The letters stated that Fannie Mae and Freddie Mac would provide additional guidance if the PACE programs moved beyond the pilot stage. These lender letters remain in effect.

In July 2010, FHFA issued a statement raising three concerns regarding PACE programs, particularly those where the PACE lien takes priority over existing mortgages. The concerns were that (1) underwriting for PACE programs results in lending based on collateral rather than on the borrower's ability to pay; (2) PACE loans lack adequate consumer protections, including those provided under the federal Truth-in-Lending Act; and (3) the programs lack (a) robust underwriting standards to protect homeowners and (b) energy retrofit standards to assist homeowners, appraisers, inspectors, and lenders determine the value of retrofit improvements. According to FHFA, the combination of these factors raised safety and soundness concerns for the secondary mortgage market.

FHFA found 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. FHFA found that first liens for such loans (1) substantially alter traditional mortgage lending practice, (2) present significant risk to lenders and secondary market entities, (3) may alter valuations for mortgage-backed securities, and (4) are not essential for successful programs to spur energy conservation.

FHFA directed Fannie Mae, Freddie Mac, and the federal home loan banks to waive their Uniform Security Instrument prohibitions against new senior liens for any homeowner who obtained a PACE or PACE-like loan with a priority first lien prior to July 2010. But with regard to new liens after that date, it required Fannie Mae and Freddie Mac to undertake actions to protect their safe and sound operations. These include:

1. adjusting loan-to-value ratios to reflect the maximum permissible PACE loan amount available to borrowers in PACE jurisdictions;

2. ensuring that loan covenants require approval or consent for any PACE loan;

3. tightening borrower debt-to-income ratios to account for additional obligations associated with possible future PACE loans; and

4. ensuring that mortgages on properties in a jurisdiction offering PACE-like programs satisfy all applicable federal and state lending regulations and guidance.

FHFA also directed the federal home loan banks to review their collateral policies in order to assure that pledged collateral is not adversely affected by energy retrofit programs that include first liens.

On August 31, 2010, Fannie Mae and Freddie Mac, citing FHFA's statement, announced to lenders that they would not purchase mortgages originated on or after July 6, 2010, which were secured by properties encumbered by PACE obligations. In effect, FHFA's actions precluded mortgages with PACE liens from being sold on the secondary mortgage market and have largely stopped the implementation of PACE programs with regard to residential properties across the country.

In February, 2011, FHFA's general counsel sent a letter to general counsel for Fannie Mae and Freddie Mac, reaffirming that debts arising from PACE programs pose significant risks to these entities. FHFA directed that Fannie Mae and Freddie Mac continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligations.

ACTIONS IN OTHER STATES

California

In the wake of FHFA's actions, the state of California, Sonoma and Placer counties, the city of Palm Desert, and the Sierra Club sued FHFA, Fannie Mae, Freddie Mac, and their directors (the claims against the directors were later dismissed). The lawsuits challenged actions by the FHFA, Fannie Mae, and Freddie Mac that allegedly blocked PACE programs. The plaintiffs sought declaratory and injunctive relief against FHFA, Fannie Mae, and Freddie Mac, arguing among other things that they had violated the requirements of the federal Administrative Procedures Act (APA) and the National Environmental Protection Act

(NEPA). Three similar cases were filed in federal district courts in Florida and New York. Cases brought by the town of Babylon and the National Resources Defense Council in New York were dismissed and the dismissals are under appeal. The case in Florida is proceeding.

In the California case, the plaintiffs alleged that defendants' actions have thwarted PACE programs. They claimed that (1) the defendants disregarded statutorily imposed procedural requirements in adopting policies about PACE debt obligations, (2) their determinations were substantively unlawful because they were arbitrary and capricious, and (3) the defendants mischaracterized the legal nature of the PACE obligations, contrary to state law, deeming them loans rather than traditional public assessments.

The defendants argued that PACE programs, particularly those that result in liens that take priority over mortgage loans, make it more difficult to sell properties with PACE loans and thus pose a risk to the security interests of entities that purchase the mortgages as investments. They moved for dismissal of the case.

The court rejected the motion for dismissal. It found that FHFA’s actions constituted substantive rule-making and these actions were performed in FHFA’s role as a regulator of the secondary mortgage market rather than as the conservator of Fannie Mae and Freddie Mac, where judicial review is limited. It concluded that plaintiffs, except for the Sierra Club, could pursue their claims for violations of the APA. (The Sierra Club's APA claims were dismissed.) The court also concluded that all of the plaintiffs had satisfied the requirements necessary to pursue claims for violation of NEPA. On the other hand, the court dismissed the plaintiffs’ other claims.

The court granted, in part, Sonoma County's motion for a preliminary injunction. It ordered FHFA, without withdrawing its July 2010 statement or its February 2011 letter, to proceed with the notice and comment process required by law with regard to those directives.

Michigan

In 2010, Michigan passed legislation (Mich. Laws 2010 Act 270) allowing municipalities and counties to establish PACE programs. The legislation authorizes municipalities to enter into PACE agreements with property owners, provide financing, and collect PACE assessments to repay the loans. Qualifying energy efficiency technologies may include electric vehicle charging and water reduction infrastructure costs, as well as the typical energy efficiency and renewable energy improvements.

Municipalities may choose to use federal grants, such as Energy Efficiency and Conservation Block Grants, or other funds to establish PACE programs.

The legislation only applies to commercial and industrial properties. In the case of loans for more than $250,000, there must be (1) ongoing measurements that establish the savings realized by the owner from the energy project and (2) a provision in the contract for the installation of an energy project that the contractor guarantee that the project will save more than its costs and that the contractor will pay the owner, on an annual basis, any shortfall in savings. The lien on the property has the same priority of tax liens (including over existing mortgages) but a property owner must obtain the written consent from the holder of a mortgage on the property in order to participate in the program.

Vermont

Vermont's initial PACE legislation gave PACE liens priority over existing mortgages. Act 47 of 2011 makes a number of substantive changes in the program. It limits PACE to residential properties, makes PACE liens subordinate to existing liens and all first mortgages, requires that PACE payments be made current on foreclosure, specifies that the PACE lien survives foreclosure, and establishes two tiers of reserve funding to provide security for PACE assessments.

Specifically, the act provides that the PACE lien is subordinate to all liens on the property in existence at the time the PACE lien is filed on the land records and a first mortgage on the property recorded after this filing. The PACE lien is superior to any other lien on the property recorded after the filing. The act does not affect the status or priority of other municipal liens, e.g. tax liens.

Prior law allowed municipalities to create reserve funds for the loans they issued. The act instead requires participating property owners to pay a one-time non-refundable fee equal to 2% of the assessment to support a statewide reserve fund created to cover losses in the event of foreclosure of participating properties. The state energy efficiency utility will administer the reserve fund. In addition, an amount equal to 5% of the assessment (not to exceed $1 million) will be transferred from funds the state receives under the Regional Greenhouse Initiative and Forward Capacity Market component of the regional wholesale electric market to an escrow account maintained by the state treasurer. This account will provide funds to cover 90% of any losses due to defaults of participating properties not covered by the reserve account.

According to Peter Adamczyk, energy finance and development manager for the Vermont Energy Investment Corporation (the energy efficiency utility), the legislation was introduced in response to FHFA's actions. Adamczyk states that the two reserve funds were needed to address the increased risk created by making the PACE lien junior to mortgages. He estimates that the program will support up to $20 million in PACE financing, enough for about 2,000 homes.

After the legislation passed the House, the state's Department of Banking, Insurance, and Health Care Administration submitted a copy to FHFA and asked whether FHFA, Fannie Mae, and Freddie Mac would "look favorably" upon the legislation. On April 6, 2011, Alfred Pollard, FHFA's general counsel submitted a letter in response. He noted that in contrast to the first lien position afforded PACE liens under the initial legislation, the bill provides for "responsible lending practices" with the PACE lien being subordinate to all existing liens and all first mortgages. He also stated that the legislation would provide "strong and uniform underwriting criteria" that would protect lenders and homeowners.

Pollard stated that FHFA supported the overall approach of the legislation, although he made five specific recommendations regarding its implementation. Subsequently PACE programs have been created in 13 municipalities, including Burlington, the state's largest city.

OPTIONS FOR MODIFYING CONNECTICUT LAW - PA 11-80

Current Law

PA 11-80 allows any municipality to establish a PACE loan program to finance energy improvements for real property located in the municipality. Under the act, the energy improvements are (1) any renovation or retrofitting of qualifying real property to reduce energy consumption or (2) installation of a renewable energy system to serve the property. Qualifying real property are single- or multi-family residential dwellings or other buildings that a municipality determines can benefit from energy improvements. The property owner must agree to participate in the program, which includes signing a contractual assessment.

Any municipality that establishes a loan program may issue bonds to (1) offer loans to the property owners to finance energy improvements, (2) conduct related energy audits, and (3) conduct renewable energy system feasibility studies and verify the installation of any improvements. The municipality can supplement the bonds with other legally available funds. The bonds and other financing must be backed by special assessments on the benefitted property.

Any loan made under the program must be repaid over a term that does not exceed the payback period for the installed improvements (the time in which the energy cost savings equal the cost of the improvements), as determined by the municipality. The municipality must set a fixed interest rate when each loan is made. The interest rate, as supplemented with available state or federal funding, must be sufficient to pay the program's financing costs, including loan delinquencies. The loan cannot have a prepayment penalty.

Loans under the program, interest, and any penalties are a lien against the property. The lien must be levied and collected in the same way as property taxes, but the lien does not have priority over existing mortgages.

Options

Connecticut's PACE law does not give PACE loans priority over existing mortgages, FHFA's primary concern, but it is unclear to what extent the law addresses FHFA's other concerns. Connecticut has at least four options for responding to the federal actions. It could (1) wait and see whether FHFA revises its policies in light of the comments it receives or litigation currently pending in California and Florida, (2) seek guidance from FHFA on the extent to which Connecticut's law fails to comply with its policies, (3) limit Connecticut's PACE programs to commercial and other properties where FHFA does not have jurisdiction, or (4) amend PA 11-80 to emulate Vermont's law.

Wait and See. In addition to FHFA's review of its policies and the on-going litigation, legislation has been introduced in Congress (H.R. 2599) that would prevent Fannie Mae, Freddie Mac, and other federal mortgage lending regulators from adopting policies that contravene established state and local PACE laws. It would also bar the regulators from discriminating against any mortgage that had a PACE lien. To be eligible for protection under this bill, the laws would have to provide for various disclosures and other consumer protections. For non-residential mortgages, the property owner would need to obtain the authorization of the holder of a first mortgage before entering into a PACE agreement. To be covered by the bill, the PACE assessment could not exceed 10% of the property's value and must meet other underwriting criteria.

Seek Guidance from FHFA. It is not clear to what extent the PACE provisions in PA 11-80 are inconsistent with federal policy. As noted above, liens for PACE loans do not take priority over existing mortgages in Connecticut. According to FHFA's letter to Vermont and our conversations with Pollard, the priority of PACE liens is FHFA's primary objection to PACE programs, although not its sole concern. Although PACE in Connecticut is a local rather than state program, the Department of Energy and Environmental Protection or other state agency could seek formal guidance from FHFA on what changes should be made to PA 11-80 to have it comply with federal policy.

Limit Scope of PACE Programs. The state could, like Michigan, limit the scope of the PACE program to commercial and industrial loans. It could also allow residential properties to participate in the program only if they did not have an existing mortgage. Under the first option, one issue for the legislature would be whether to require the property to owner to obtain the authorization of the holder of any existing mortgage or merely to notify the mortgagee.

Emulate Vermont. As noted above, FHFA has commented favorably on Vermont's legislation and PACE programs are being implemented there. The legislation makes PACE loans subordinate not only to existing mortgages but also to subsequent first mortgages. It establishes reserve funds to offset the increased risk associated with the loss of priority for PACE loans.

In addition, Vermont's original legislation contains several provisions that are not found in PA 11-80 and might help address FHFA's concerns if adopted in Connecticut. For example, the law requires municipalities that establish PACE programs to (1) follow underwriting criteria consistent with standards established by the Department of Banking, Insurance, Securities, and Health Care Administration and (2) establish other qualifying criteria to provide an adequate level of assurance that property owners will have the ability to meet assessment payment obligations. The law also limits the maximum amount to be repaid for an individual improvement project to $30,000 or 15% of the property's assessed value, whichever is less.

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