September 12, 2012

Via Electronic Mail

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street, SW
Washington, DC 20024
(Comments/RIN 2590-AA53)


Dear Mr. Pollard,


Property-Assessed Clean Energy (“PACE”) programs allow local governments to finance renewable energy systems and energy and water efficiency retrofits for their residents by using longstanding property assessment powers. Because Fannie Mae and Freddie Mac (together, the regulated “Enterprises”) guarantee or own approximately half of all residential mortgages nationwide, this rule will have a significant impact on residential PACE programs across the nation.

In our view, there is a serious question as to whether the Agency’s Proposed Rule would survive judicial review on the record as it currently stands. A reviewing court would be troubled, in our opinion, by the failure of the Agency to consider important material in the record or to elaborate its justifications for rejecting important arguments that favor the third risk-mitigation alternative.

A more legally defensible decision would be to adopt the third risk-mitigation alternative as the Final Rule: allow the Enterprises to consent to first-lien PACE obligations that satisfy the key underwriting standards set forth in H.R. 2599, the PACE Assessment Protection Act of 2011. We urge FHFA to carefully consider the existing evidence of economic and community benefits from PACE programs, and adopt the third risk-mitigation alternative as its Final Rule.
I. Introduction

The Center for Law, Energy & the Environment (“CLEE”) is an academic research center at UC Berkeley School of Law. CLEE’s mission is to develop pragmatic law and policy solutions to the most pressing environmental and energy issues at the state, national and local levels. CLEE also serves an important convening and consensus-building role, bringing together environmental and energy law policymakers, legal practitioners, business leaders, non-profits, students, and academic experts to develop solutions to environmental and energy challenges.

One of CLEE’s priority research areas is advancing the transition to renewable energy in California and nationwide. CLEE recently published reports on meeting the California Governor’s goals for securing 12,000 megawatts of distributed generation by 2020, the statewide benefits of net metering, and legal uses of California’s cap-and-trade auction proceeds.

CLEE has reviewed the comment letters submitted in this rulemaking to-date, the empirical studies cited by these commenters, and H.R. 2599, the bi-partisan “PACE Assessment Protection Act of 2011.” CLEE urges FHFA to adopt the third risk-mitigation alternative as set forth in its Proposed Rule.

II. Background

Property Assessed Clean Energy (PACE) is a bipartisan state and local government program that allows property owners to obtain upfront funding for energy efficiency retrofits from their local government, and repay these costs over a period of years through annual assessments on their property tax bill. If a homeowner sells his or her property, the PACE assessment and property improvements transfer to the new owner.

Residential and commercial buildings account for almost 39 percent of total U.S. energy consumption and 38 percent of U.S. carbon dioxide (CO2) emissions. Therefore, retrofitting buildings to reduce energy consumption is a critical step in addressing climate change, with the added benefits of cutting utility bills, reducing reliance on fossil fuels, and creating local jobs.

Residential PACE programs—at issue in this rulemaking—solve two of the most substantial barriers to homeowners installing energy-saving upgrades: significant up front capital and uncertainty as to the period of homeownership. Since 2009, twenty-seven states and the District of Columbia have enacted PACE programs.

Residential PACE programs nationwide have been effectively halted due to public pronouncements by FHFA and the enterprises it manages, Fannie Mae and Freddie Mac (hereinafter “the Enterprises”). In a July 6, 2010 Statement, FHFA stated that the first liens created by residential PACE programs posed “significant risk” to lenders, servicers, and

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2 The FHFA Statement and this rulemaking affect residential properties only. Mortgages on commercial properties are not purchased by Fannie Mae and Freddie Mac and are unaffected by this rulemaking.
mortgage security holders.\textsuperscript{3} FHFA directed that the Enterprises “undertake prudential actions to protect their enterprises,” including ensuring that loan covenants require approval/consent for any PACE loans, and tightening borrower debt-to-income ratios. Following FHFA’s statement, in August 2010, Fannie Mae and Freddie Mac announced to lenders that they would not purchase any mortgages originated on or after July 6, 2010 which were secured by properties encumbered by a PACE lien.\textsuperscript{4} FHFA issued a Directive on February 28, 2011, instructing the Enterprises to “continue to refrain from purchasing mortgage loans secured by properties with outstanding first-lien PACE obligation.” These actions effectively thwarted residential PACE programs throughout the country.

Several parties nationwide filed lawsuits challenging these Agency actions, including the State of California, several California counties, municipalities, and the Sierra Club.\textsuperscript{6} Co-plaintiff Sonoma County moved for a preliminary injunction requiring FHFA to institute a notice and comment period regarding its July 2010 letter, in order to comply with the Administrative Procedure Act (“APA”). A Northern District of California court granted the California plaintiffs' request for a preliminary injunction requiring FHFA, without changing its current policy, to proceed with a public notice and comment process concerning its PACE pronouncement.\textsuperscript{7} In an August 8, 2012 summary judgment order, the Northern District of California court held that FHFA must follow the notice and comment process, as FHFA’s statements and directives on PACE obligations amounted to substantive rulemaking.\textsuperscript{8}

On June 15, 2012, FHFA released its Proposed Rule. The Proposed Rule would maintain FHFA’s prior position on PACE programs, and provides that:

1. The Enterprises shall immediately take such actions as are necessary to secure and/or preserve their right to make immediately due the full amount of any obligation secured by a mortgage that becomes, without the consent of the mortgage holder, subject to a first-lien PACE obligation;
2. The Enterprises shall not purchase any mortgage that is subject to a first-lien PACE obligation; and
3. The Enterprises shall not consent to the imposition of a first-lien PACE obligation on any mortgage.\textsuperscript{9}

\textsuperscript{5} Letter from Alfred M. Pollard, FHFA (Feb. 28, 2011) to General Counsels of Fannie Mae and Freddie Mac Re: PACE Programs. On file with author.
\textsuperscript{6} The California cases have been consolidated.
FHFA also set forth three “risk-mitigation alternatives,” described by the Agency as “alternative means of mitigating the financial risks that first-lien PACE programs would otherwise pose to the Enterprises.” The three alternatives are:

1. Repayment of the PACE obligation is irrevocably guaranteed by a qualified insurer, with guarantee triggered by any default or foreclosure.

2. The PACE lien satisfies protective standards set by FHFA, including limiting the PACE obligation to no greater than $25,000 or 10% of the fair market value of the underlying property, whichever is lower; combined loan-to-value ratio of no more than 65%; borrower’s debt-to-income ratio no greater than 35%; borrower’s FICO credit score not lower than 720; and the Enterprises are to treat a home purchaser’s prepayment of an existing first-lien obligation as an element of the purchase price in determining loan amounts and applying underwriting criteria.

3. The Enterprises may consent to first-lien PACE obligations that satisfy the key underwriting standards set forth in H.R. 2599, the PACE Assessment Protection Act of 2011. These standards require, among other provisions:

   • **Minimum equity.** Homeowners must have at least 15% equity in the home;
   • **Limited size.** PACE assessments are capped at 10% of the value of the home;
   • **Past performance criteria.** Homeowners must be current and on-time with tax and mortgage payments;
   • **Audit and evaluation.** Projects require an approved energy audit to ensure that only cost-effective energy efficiency projects are undertaken, and that any improvements funded by PACE are expected to be affixed to the property for the useful life of the improvement based on measures approved by the Department of Energy;
   • **Clear title.** There may be no liens, bankruptcy, or defaults on the property;
   • **Non-acceleration.** PACE assessments may not accelerate upon foreclosure;
   • **Savings-to-investment ratio.** The total energy and water cost savings during the useful lives of the improvements must be expected to exceed the total cost of to the property owner and property owner’s successors; and
   • **Time limit.** The maximum term of the PACE assessment may be no longer than the shorter of (a) 20 years from inception, or (b) the weighted average expected useful life of the PACE improvement(s).

A substantial majority of the comment letters submitted in this rulemaking at the Advance Notice stage are supportive of PACE programs and urge that FHFA rescind its Directive. Many of the comments favor of the third risk-mitigation alternative, adopting H.R. 2599’s underwriting standards.

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III. Legal Standard Under the Administrative Procedure Act

Any regulations issued by FHFA pursuant to its general regulatory authority must comply with the APA’s requirements for notice and comment. In addition, the Agency must satisfy the “arbitrary and capricious” standard upon judicial review, which requires the Agency to consider all evidence at its disposal, consider alternatives to a flat ban on the program, and demonstrate a rational connection between the facts it found and the choice it made. While courts generally offer significant deference to an agency’s technical expertise, they do review closely whether the agency properly analyzed the evidence and alternatives presented.

The Supreme Court explained the APA’s standard of review in Motor Vehicle Manufacturers’ Association of the United States v. State Farm Mutual Automobile Insurance Company, 463 U.S. 29 (1983). In State Farm, the Supreme Court found that the agency in question, the National Highway Traffic Safety Administration (NHTSA), had been too quick to dismiss the safety benefits of automatic seatbelts and failed to consider the alternative of requiring air bags, alone. The Court held that the agency acted arbitrarily and capriciously in revoking the requirement that new motor vehicles be equipped with passive restraints to protect the safety of the occupants, and the agency failed to present an adequate basis and explanation for rescinding this requirement. The Court stated that the agency must examine the relevant data and articulate a satisfactory explanation for its action including a “rational connection between the facts found and the choice made.”

Pursuant to the APA’s requirements, FHFA must solicit and consider existing evidence on the potential risks and benefits of PACE. The Agency cannot rely on unsupported assumptions that PACE poses financial risks to the Enterprises. This is especially important in light of the evidence that homeowners who receive PACE funding for qualified improvements have been found to be less likely to default on their mortgages than other borrowers, and that homes with energy efficiency upgrades sell for a premium over homes without such improvements.

In addition, FHFA must consider all relevant alternatives to a flat ban of PACE programs nationwide. Pursuant to State Farm, the Agency does not have discretion to ignore apparently reasonable courses of action without offering a satisfactory explanation and engaging in analysis. FHFA must assess the three risk-mitigation alternatives presented in its Proposed Rule, as well as other viable options for minimizing any alleged risks to the Enterprises caused by PACE programs, such as operating pilot programs in select cities nationwide in order to gather additional relevant data. As articulated below, we believe the most reasonable course of action is adopting the third risk-mitigation alternative.

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14 State Farm, 463 U.S. at 41-43.
15 Id. at 43 (citing Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).
16 This evidence is explained in Part V of these comments.
IV. Legal Precedent for PACE as a Land-Secured Assessment District

A number of states have PACE-specific laws that allow municipalities to create special assessment districts for the purpose of financing homeowners’ upfront costs for energy efficiency improvements. Special assessments, however, are not a new concept. Most states, including California, had statutes in place prior to the development of PACE that allow municipalities to create special assessment districts for the purpose of improving local infrastructure and protecting community health.¹⁸ As of 2007, there were 37,000 special assessment districts in the United States.¹⁹

The FHFA Statement, which effectively halted PACE programs throughout the country, stated 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. The size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.”²⁰ In its Advance Notice of Proposed Rulemaking (“ANPR”), FHFA again distinguished PACE liens from traditional assessments by stating that PACE liens are “voluntary - homeowners opt in.”²¹ And in its Proposed Rule, FHFA states that PACE programs are different because they involve a “single property,” rather than a community-wide benefit that homeowners cannot opt out of.²²

Contrary to FHFA’s statements, PACE utilizes a form of municipal financing that has been in existence for more than a century, and the size, duration, and community-wide benefits provided by PACE programs are firmly in line with long-standing local assessment powers. Special assessment districts have a long tradition in the United States extending back at least 100 years.²³ Special assessments have been applied to finance a wide array of public improvements ranging from sidewalks, curbs, sewers, seismic upgrades on private property, septic upgrades, business improvements, security improvements, and street lights. In addition, state statutory frameworks frequently structure assessment districts to have priority lien status over preexisting mortgages.²⁴

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¹⁹ See U.S. Census Bureau, Local Governments and Public School Systems by State: 2007, available at http://www.census.gov/govs/cog/GovOrgTab03ss.html. Data from 2007 is the latest available; 2012 data is currently being collected.


²² FHFA Proposed Rule at 36105.

²³ See German Sav. & Loan Soc’y v. Ramish, 138 Cal. 120 (1902) (upholding priority of assessment lien for street improvements over preexisting mortgage).

Moreover, it was the FHFA and Enterprises’ practice to allow these special assessments to proceed and take first-lien status over preexisting mortgages, without the need for rigorous underwriting criteria. The Department of Energy (DOE) Guidelines for Pilot PACE Financing Programs, written in 2010 prior to FHFA’s pronouncement on PACE, expressly set out to provide underwriting criteria for PACE financing that would be “significantly more rigorous than the underwriting standards currently applied to land-secured financing districts.”²⁵ H.R. 2599 expands upon these DOE guidelines and best practices. Therefore, the Agency’s rejection of PACE programs—even with H.R. 2599’s underwriting criteria—is a notable departure from its prior acceptance of land-secured financing districts.

Similarly, the duration of the assessment does not make PACE programs more risky than other traditional land-secured assessments, which can range from ten to fifty years. H.R. 2599’s underwriting standards limit the duration of PACE programs to no more than twenty years or the weighted average expected useful life of the PACE improvement or improvements, whichever is shorter.²⁶ Many existing state programs codify this time limit.²⁷ In addition, PACE assessments run with the property, and properly structured PACE legislation, such as California’s PACE law, does not accelerate the entirety of the PACE financing in the event of default. Only delinquent assessment payments would become due immediately, and the remainder of the assessment would be passed on to next homeowner. Given these restrictions—required by alternative three—PACE improvements should pose no more risk to lenders and loan servicers than other traditional, historically accepted tax assessments that have first lien status. In fact, properly structured PACE programs should actually decrease risk to the Enterprises because they are designed to reduce net costs to the homeowner.

FHFA’s attempt to distinguish PACE assessments by stating that they “do not have the traditional community benefits associated with taxing initiatives” is likewise unavailing.²⁸ PACE programs provide similar local, community-wide benefits that other public-purpose tax liens do for services such as sewers, streets, and lighting. Energy and water efficiency upgrades and local renewable energy generation provide local community benefits such as:

- Reduced energy consumption;
- Increased water conservation from water efficiency upgrades;
- Reduced air pollution and particulate matter produced by fossil-fuel power plants, which provides community-wide health and environmental benefits;
- Reduced greenhouse emissions, which may assist cities in meeting GHG-reduction goals;

²⁶ H.R. 2599 at 18.
²⁸ FHFA PACE Statement.
• Creation of new jobs in renewable energy, installation, and energy efficiency within the community itself;
• Lower energy and utility bills, especially where net-metering is available; and
• Increased energy grid security, benefitting the community by minimizing disruptions caused by transmission line or power plant outages.

Finally, the “opt-in” component of PACE programs is simply immaterial, as many land-secured assessments are voluntary. Examples include the City of Torrance, California, which funded voluntary seismic retrofits, and the Massachusetts Community Septic Program, which encouraged homeowners to voluntarily upgrade their septic systems by applying for local government financing. Many of the comments submitted in this rulemaking describe other voluntary or “opt-in” land-secured assessments that pre-date FHFA’s current rejection of PACE programs. Indeed, it seems counterintuitive that the Agency points to this feature as a negative characteristic of PACE programs, as it later states that PACE programs’ “rapid proliferation” increases the magnitude of risk that they present to the Enterprises. Because these programs are voluntary or “opt-in,” they may attract more informed property owners whom FHFA admits may be less likely to default on their PACE obligations and mortgage payments. In addition, the “opt-in” feature protects homeowners and lenders by allowing those who benefit from lower energy bills to incur the cost of the improvements, and by structuring the improvements to have a savings-to-investment ratio greater than one.

In sum, PACE has the same characteristics as traditional land-secured assessment districts in the United States. Longstanding local government authority provides that communities may create such assessment districts in order to finance health, environmental, or property-related improvements. The PACE underwriting standards set forth in H.R. 2599, as well as the “best practices” articulated in DOE’s PACE Guidelines, are designed to ensure that PACE programs preserve local government authority to control local energy and water resources, air quality, and job creation, while reducing risk to FHFA and the Enterprises it regulates. This guidance should be carefully considered by FHFA before maintaining its blanket prohibition on PACE programs, especially in light of the existing positive evidence from PACE and the absence of negative data showing any “unacceptable level of risk” posed by these programs.

V. Relevant Data on Home Values and Default Rates Demonstrates that PACE Programs Provide Economic Benefits to Homeowners and Mortgage Holders, Rather Than Create Any Increased Risk

In its 2010 statements and Advance Notice of Proposed Rulemaking, FHFA repeatedly comments that PACE programs “pose unusual and difficult risk management challenges,” and “[PACE] programs present significant safety and soundness concerns.” However, FHFA lacks concrete data that demonstrates this increased risk. Rather, the data before us shows that PACE

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programs have lower than average default rates, and that homes with energy efficiency upgrades or renewable energy systems sell for a premium over homes without such upgrades. To the extent FHFA considers this evidence inconclusive, it should work with DOE and other interested stakeholders to test its currently unsupported hypothesis by allowing PACE programs to proceed with H.R. 2599’s underwriting criteria in place. To simply assume that PACE programs pose this risk without any data to support this conclusion contravenes the very purpose of the APA’s notice and comment process.

First, data shows that homeowners who install energy efficiency improvements or renewable energy generators are likely to increase the value of the property, benefitting lenders, loan servicers, local communities and homeowners. Relevant studies include:

- A 2011 Lawrence Berkeley National Laboratory assessment of 72,000 homes showing an average $17,000 sales price premium for homes with photovoltaic systems;31
- A 2011 study published in the Journal of Sustainable Real Estate finding that homes with ENERGY STAR ratings sell for $8.66 more per square foot than comparable homes without this rating; and
- A July 2012 UCLA and UC Berkeley report finding an estimated 9% price premium for ENERGY STAR certified California homes relative to similar homes that are not certified.33
- An August 2012 study in the European Economic Review surveyed a large sample of homes in the San Diego and Sacramento, California areas to compare the sales value of homes with solar panels relative to comparable homes without solar panels. The study found that solar panels are capitalized at roughly a 3.5% premium, after controlling for flexible neighborhood price trends. This corresponds to a predicted $22,554 increase in price for the average home sale with solar panels installed.34

In contrast to this data and analysis, there is no data cited in the Advance Notice of Proposed Rulemaking or Proposed Rule that supports the position that PACE projects may decrease home values.

Second, most PACE programs are designed to save homeowners money by reducing utility bills by a greater amount than is spent on the PACE assessment. Indeed, alternative three in this rulemaking would require this. Thus, these homeowners will be in a better position to pay off their mortgages if this alternative is adopted. The data currently available shows that a

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positive correlation exists between homes with energy efficiency improvements and lower default and delinquency rates.

Data submitted to PACENow from PACE programs in Sonoma County (CA), Boulder County (CO), and Babylon (NY) shows that of 2,723 properties with PACE liens there have been 24 defaults, translating to a default rate of .88 percent.\footnote{PACENow Comment Letter to FHFA (March 25, 2012) at 9, available at http://www.fhfa.gov/webfiles/23780/348_PACENow.pdf.} In comparison, the national percentage of mortgage loans in foreclosure at the end of the fourth quarter 2011 was 4.38 percent.\footnote{Mortgage Bankers Association, \textit{Press Release: Delinquencies and Foreclosures Decline in Latest MBA Mortgage Delinquency Survey} (Feb. 16, 2012), available at http://www.mortgagebankers.org/NewsandMedia/PressCenter/79827.htm.} Sonoma County’s letter in this rulemaking describes its program data in more detail, and shows that year after year, PACE assessment mortgage and tax delinquency rates were significantly lower than the County’s overall mortgage and tax delinquency rates.

Finally, in addition to evidence showing property value increases and lower default rates, PACE programs also provide economic benefits to local communities and the United States. One study by EcoNorthwest concluded that $4 million in total PACE project spending can generate $10 million in gross economic output, $1 million in combined Federal, State and Local tax revenue, and 60 jobs.\footnote{EcoNorthwest, Economic Impact Analysis of PACE (April 2011), available at http://pacenow.org/wp-content/uploads/2012/08/EcoNorthwest-Economic-Analysis-of-PACE1.pdf.} Another study conducted in 2011 by the DOE on the economic impacts of the Boulder County Climate Smart (PACE) Loan Program found that $9 million spent on energy efficiency or renewable energy projects on 598 homes contributed, statewide, to more than $7 million in earnings, approximately $20 million in total economic activity, and the creation of roughly 125 short-term jobs.\footnote{U.S. Department of Energy, National Renewable Energy Laboratory, “Economic Impacts from the Boulder County, Colorado, ClimateSmart Loan Program: Using Property-Assessed Clean Energy Financing,” July 2011, available at http://www.nrel.gov/docs/fy11osti/52231.pdf.}

In short, PACE programs are designed to increase a property’s value and to reduce risks to homeowners and lenders. In addition, these programs provide valuable community health, environmental and economic benefits. While we may need more data to assess the effect of energy efficiency upgrades across wide markets and different residential price points, the data we currently have on home values and quantitative risk to the Enterprises supports the continuation of PACE programs. A reasonable approach would be to allow these programs to continue as they are, or to require programs to adopt the underwriting standards set forth in H.R. 2599 for an additional layer of protection against any real or perceived risk.

VI. Conclusion

Climate change and dependence on fossil fuels are two of the most pressing and complex issues of our time. These challenges will not be easily overcome, especially without innovative approaches to reducing energy consumption. Residential PACE programs are a promising tool to reduce energy consumption and provide community health and economic benefits.
Berkeley Law’s Center for Law, Energy & the Environment maintains that FHFA, through the third risk-mitigation alternative, can ensure that eligibility requirements for homeowners in residential PACE programs conform to standards that extend additional protection to mortgage lenders and the Enterprises. This additional layer of protection may not even be necessary, as the data before us demonstrates that some PACE programs actually reduce risk to lenders and mortgage holders. Nevertheless, the underwriting standards set forth in in H.R. 2599 should mitigate any concerns that FHFA had with previous PACE programs.

Finally, we encourage FHFA to meet with DOE and other interested stakeholders to set a methodology for data collection and reporting by participating states and municipalities. Thank you for this opportunity to comment on FHFA’s Proposed Rule.

Sincerely,

Jayni Foley Hein
Executive Director
Center for Law, Energy & the Environment
UC Berkeley School of Law

Attachments [Note: Additional materials cited have been submitted under separate cover.]