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Enact Legislation Supporting Residential Property Assessed Clean Energy Financing (PACE)

Devashree Saha

Summary

Congress should enact legislation that supports residential property assessed clean energy (PACE) programs in the nation's states and metropolitan areas. Such legislation should require the Federal Housing Finance Agency (FHFA) to allow Fannie Mae and Freddie Mac to purchase residential mortgages with PACE assessments while at the same time providing responsible underwriting standards and a set of benchmarks for residential PACE assessments in order to minimize financial risks to mortgage holders. Congressional support of residential PACE financing will improve energy efficiency, encourage job creation, and foster economic growth in the nation's state and metropolitan areas.

Background

In the aftermath of the Great Recession, the U.S. needs to move toward a new economic growth model, a "next economy" in which the nation takes the lead in the clean economy by accelerating the development and adoption of the energy efficiency and renewable energy technologies necessary for a low carbon future. Given that the clean economy could trigger a market transformation as profound as the information revolution, the U.S. needs to fully engage in the clean economy—which is expected to grow four-fold to more than $2 trillion by 2020.

Along these lines, a first priority for unleashing clean economy growth in the nation must be to catalyze stronger market demand for energy efficiency and renewable energy products and services in the residential, commercial, and institutional markets. Of particular note here is the market potential of energy efficiency and renewable energy upgrades and retrofits in buildings. Since buildings consume nearly half (48.7 percent) of the nation's primary energy and are also responsible for half of the carbon emissions, such upgrades and retrofits offer the potential for significant economic, employment, and climate benefits. Given that, it has been estimated that scaling up energy efficiency retrofits offers a $279 billion investment opportunity with potential for energy savings totaling more than $1 trillion over a period of 10 years—of which $182 billion of investment potential is tied to residential energy efficiency upgrades alone.

Cities and states across the nation—motivated by challenges of escalating energy costs and the significant economic benefits of energy efficient solutions—have led the nation through their efforts to retrofit the residential, commercial, and public buildings in their jurisdictions. At the same time though, cities and states have contended with a number of challenging market barriers that prevent the energy retrofit market from scaling up, including perceived risk of investing in energy retrofit projects, high transaction costs, and inadequate access to capital.

Given these financing challenges, property assessed clean energy (PACE) programs have attracted attention as an innovative financing mechanism for energy retrofit upgrades. PACE is a financing structure that enables states and local governments to use money raised through bond issues or other sources of capital to fund energy efficiency and renewable energy upgrades. These funds are used as upfront financing for upgrades to residential and commercial properties, recovered by the governmental entity through a special property tax assessment that runs with the land for up to 20 years. The PACE special district structure thus overcomes market barriers to energy upgrades by spreading cost recovery with savings realized over the life of the improvement.

First piloted in 2008, PACE programs quickly spread throughout the country and today 28 states and the District of Columbia have passed PACE-enabling legislation. As a result, PACE programs have enjoyed significant success in many cities and counties. Palm Desert, CA's PACE program, for example, has approved $8.5 million in projects to date. Sonoma County's program, meanwhile, has financed over $55 million in projects for 1,600 residential and 50 non-residential property owners.

What's more, studies analyzing the economic effects of PACE programs suggest that they have the potential of generating significant positive economic and fiscal benefits. One study found that $4 million in total PACE spending can generate on average $10 million in gross economic output; $1 million in combined federal, state, and local tax revenue; and 60 new jobs. Extrapolating from this study, if just one percent of the 75 million owner-occupied homes in the U.S. were to invest in a PACE project that cost an average of $20,000 each, the economic impact would translate to $15 billion in gross economic output; $4 billion in combined federal, state, and local tax revenue; and 226,000 new jobs.

The Problem

And yet, for all their promise, neither energy retrofit projects in general nor residential PACE programs specifically have achieved their full potential.

Part of the problem owes to the well-known market barriers that depress demand, including: a status quo bias, difficulty in quantifying energy savings from retrofits and upgrades, lack of information about existing energy inefficiency in homes and what can be done about it, high up-front costs, and difficulty identifying quality contractors.

In addition, and perhaps more significantly, the Federal Housing Finance Agency (FHFA) has blocked the scale-up of residential PACE programs.

In July 2010, just as residential PACE programs were gathering momentum, the FHFA issued a statement asserting that PACE programs constituted first liens over pre-existing mortgages, thereby creating significant risks for lenders, servicers, Fannie Mae and Freddie Mac, and other mortgage holders. Despite evidence to the contrary, the FHFA deemed these risks unacceptable and instructed Fannie Mae and Freddie Mac to restrict the kind of loans that homeowners could get if they live in a PACE-designated area. This ruling effectively ended residential PACE financing, with many local governments suspending their programs as a result. Commercial PACE programs were not affected by the FHFA decision and have been moving forward in various places.

The FHFA ruling on residential PACE financing has resulted in:

- The cessation of almost all existing PACE programs focused on the residential sector out of concern that mortgages in PACE-designated areas would fail to receive the backing of Fannie Mae or Freddie Mac

- Redirection of nearly $150 million in federal Recovery Act funds that had originally been designated to support the implementation and operation of residential PACE programs throughout the U.S.

Despite efforts by advocates of PACE to address FHFA concerns, the FHFA ruling against residential PACE financing persists. Meanwhile, some states have challenged the FHFA ruling in federal court, though such efforts have thus far proven unsuccessful in changing FHFA's stance. A federal district court in California—while not ordering the FHFA to reverse its current position on underwriting mortgages for properties with a PACE assessment—directed the agency to proceed with a notice and comment period for rulemaking. The FHFA took comments on proposed rules until September 2012 and it is not clear how long it will take to finalize the proposed rules or what the outcome will be. In addition, there have been a number of attempts to resolve the residential PACE issue through legislative action, including the PACE Assessment Protection Act (H.R. 2599), introduced in July 2011, that would prevent the FHFA and mortgage underwriters from discriminating against localities participating in or implementing a PACE program. To date, however, no legislation supporting residential PACE programs has been passed.

Proposal

The Metropolitan Policy Program at Brookings therefore proposes that **Congress enact legislation that would require the FHFA to allow Fannie Mae and Freddie Mac to purchase residential mortgages with PACE assessments and incorporate underwriting standards protecting lenders and program standards for states and local governments offering PACE programs.** These underwriting standards should be aligned with the PACE guidelines released by the Department of Energy in May 2010.

Along these lines, Congressional support of residential PACE programs would:

- **Send a strong signal** that the U.S. remains fiercely committed to investing in smart, innovative financing structures that can catalyze the energy retrofit market

- **Enable states and local governments**—many of which suspended their residential PACE programs in the wake of the FHFA ruling—to design and implement such programs in their communities

- **Save money for homeowners** by reducing energy costs

- **Create new jobs and career opportunities** in both the energy efficiency and renewable energy industries

- **Reduce greenhouse gas emissions** and so produce significant climate benefits

Congressional support of residential PACE financing has the potential to inject billions of dollars into the U.S. economy while at the same time making lasting energy improvements in the nation's metropolitan areas.

Budget Implications

Congressional action to support residential PACE programs would have no budgetary impact. If legislation is passed, it will restore local governments' ability to offer residential PACE programs and help homeowners finance energy efficiency and renewable energy upgrades without any government subsidies or expenditures.

State of Play

Broad support for residential PACE programs exists across a wide group of entities and organizations, including local and county governments, state governments, state and federal elected representatives, national municipal associations, clean energy trade organizations, and businesses and business councils. The FHFA ruling notwithstanding, the federal government has strongly supported residential PACE programs and issued best practices guidelines in 2010 as a first step toward national standardization of PACE financing mechanisms. Congressional support for residential PACE financing exists on both sides of the aisle, as evidenced most recently by the PACE Assessment Protection Act (H.R. 2599), a bipartisan bill supported by 21 Republicans and 32 Democrats that was introduced in July 2011.

Despite this broad support for residential PACE programs as well as court challenges and a federal district court ruling in California requiring the FHFA to initiate rulemaking on residential PACE financing, the FHFA maintains its opposition to Fannie Mae and Freddie Mac purchasing otherwise conforming mortgages with PACE assessments.

Implementation Requirements

Legislative action would be required to support residential PACE financing programs.

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About the Author

Devashree Saha is a senior policy analyst and associate fellow at the Brookings Metropolitan Policy Program.

For More Information

Mark Muro
Senior Fellow and Policy Director
Brookings Metropolitan Policy Program
202.797.6315
mmuro@brookings.edu

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For General Information

Metropolitan Policy Program at Brookings
202.797.6139
www.brookings.edu/metro

1775 Massachusetts Avenue NW
Washington, D.C. 20036-2188
telephone 202.797.6139
fax 202.797.2965