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Accelerating the Payment of PACE Assessments

By Mark Zimring and Merrian Fuller

The “acceleration” of land-secured assessments¹ allows municipalities to declare the *entire* value (not just the late payments) of a property owner’s outstanding balance payable if a default² occurs. State laws vary on whether acceleration is required, permitted, or prohibited. Acceleration can be attractive to bond investors because it strips out non-performing assessments, and may avoid delays in debt service payments to investors. The risk that non-acceleration will negatively impact bond investors is a particular issue in states without a process for rapidly resolving defaults.³ However, acceleration may also increase the risk to mortgage holders, as the full amount of the outstanding assessment becomes due and traditionally has priority over other lien holders. Acceleration also places a greater burden on the property owner.

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¹Land-secured financing districts (often called special tax districts or special assessment districts) have been used for more than 100 years in the U.S. to pay for infrastructure improvements deemed to be in the public interest, including improvements on private property. Property Assessed Clean Energy (PACE) financing programs allow state and local governments, to extend the use of land-secured financing districts to fund energy efficiency and renewable energy improvements on private property by amending existing state law. For more information on PACE programs, please visit: <http://www1.eere.energy.gov/wip/solutioncenter/financialproducts/PACE.html>

² We use the terms “default” and “delinquency” interchangeably in this policy brief. We found that the language and definitions for default/delinquency for land-secured assessments vary between states. By default/delinquency we mean the type of non-payment that triggers the placement of an involuntary tax lien on the property; for example this might be a certain number of missed payments or a dollar amount of outstanding payments that are due, depending on the state law and local discretion about when the involuntary tax lien is placed.

³ Default resolution may entail property owners making the delinquent payments or paying the full outstanding assessment balance if there is acceleration. To the extent property owners fail to make these payments, default resolution may include property foreclosure.

The issue of whether PACE programs should be structured such that liens are accelerated upon default has attracted some attention from program designers and policy makers. The White House's Policy Framework for PACE Financing Programs explicitly supports designing PACE programs such that property owner default does *not* trigger acceleration of the assessment.⁴ Ultimately, the importance of this issue varies greatly due to the differences in acceleration requirements and default resolution practices in each state.

PACE and Municipal Revenue Bonds: A Key to Accessing Private Capital

Comprehensive energy efficiency retrofits to upgrade the U.S. commercial and residential building stock will cost over \$1 trillion.⁵ It is essential that retrofit programs harness private capital to achieve the scale required to tap into our energy savings potential and significantly reduce our greenhouse gas emissions. One option that many local governments are considering is selling limited obligation bonds secured by PACE assessments. With bond financing, local governments create PACE programs, and private investors fund the property owners' retrofits by purchasing PACE assessment bonds. Once assessments are in place, local governments collect special assessment payments from property owners and repay bond investors with interest.

How Property Assessment Acceleration Works

When acceleration occurs, a tax lien is recorded against the property due to a failure to make assessment payments, and the property owner is given an opportunity to eliminate this lien by paying off the *entire* outstanding assessment amount (not just the late payments). If the property owner fails to do so, a tax lien sale may occur. In a tax lien sale, the government agency to whom assessment payments are owed sells the special assessment lien to a third party. These special assessment liens are traditionally senior to almost all other debt, and their balance must be paid before subordinated debt holders, such as mortgage holders, can begin foreclosure proceedings. In many cases, these accelerated assessments are a small fraction of a property's value, and subordinated debt holders often purchase the tax lien in order to avoid owing penalty interest when the property is eventually re-sold.⁶ If these liens are attached to special assessment bonds, the local government uses the proceeds of this tax sale to retire the debt for that property. Mortgage holders are then free to commence foreclosure proceedings. Upon the conclusion of the foreclosure process, mortgage holders take title to the property and use property sale proceeds to recover both the value of their loan and, if they purchased the tax lien, the cost of the lien.⁷ The former property owner then receives any excess proceeds.

Non-Acceleration: Protecting Mortgage Holders and PACE Participants

⁴ The Policy Framework for PACE Financing Programs is available here: http://www.whitehouse.gov/assets/documents/PACE_Principles.pdf

⁵ The Center for American Progress reports that retrofitting 40% of the U.S. building stock would require public and private investment of \$500 billion: http://www.americanprogress.org/issues/2009/08/rebuilding_america.html

⁶ Penalty interest is the interest charged by local governments for late payments.

⁷ If property sale proceeds are less than loan value and tax lien cost, mortgage holders may not recover the full value of their investment.

Lien non-acceleration means that, when a default occurs, only the assessment amount in arrears, plus penalties and interest, must be paid.⁸ The balance of the assessment will be billed on the agreed-upon schedule and is not accelerated. Non-acceleration provisions provide an added layer of protection for mortgage holders and program participants.

Protecting Mortgage Holders

With non-acceleration, subordinate creditors only need to pay the delinquent payments, plus penalties and interest, at or before tax sale in order to protect their subordinate interests, not the entire outstanding assessment amount. According to an attorney who specializes in foreclosing delinquent special taxes and assessments on behalf of local agencies in California, in virtually all cases in California involving developed property and institutional lenders, the lenders pay the delinquent installments to resolve the default and protect their private lien.⁹ The balance of the PACE assessment will remain an obligation of the property when it is purchased.

Protecting Property Owners

Non-acceleration protects participating property owners by minimizing the size of the payment they must make to resolve an assessment delinquency and return to the previously agreed upon installment schedule. Additionally, penalties and interest accrue only on the overdue assessment installments, not the full value of the outstanding PACE lien. As such, non-acceleration provisions increase the likelihood that property owners will be able to resolve assessment delinquencies before losing their properties in foreclosure.

Assessment Default Impact on PACE Bond Investors

It is reasonable to anticipate that PACE programs will experience low property owner delinquency rates for a variety of reasons, including (i) energy savings will offset and, in some cases, exceed the assessment payments and (ii) most PACE programs will finance improvements primarily to developed residential property, which are considered to be the safest credit from a land-secured bond perspective. If property owners default on their assessments, bondholders are ultimately likely to receive full payment of debt service on their bonds because of the seniority of the PACE lien and its small value compared to overall property value. However, ongoing cash-flow interruptions could create uncertainty about when debt service payments will be made, thus potentially negatively impacting bond value. Large and diverse PACE assessment pools, rapid default resolution processes, and debt service reserve funds can mitigate the risk of assessment delinquencies for investors. Default resolution speed is largely a function of state law, and timely resolutions can be achieved with acceleration but also with a streamlined process to recover delinquent payments, penalties, and interest.

Non-Acceleration Impact on PACE Bond Investors

The impact of non-acceleration provisions on investors will vary from state to state. Here, we describe the experiences with acceleration issues in California and Boulder County, Colorado to highlight the different impacts non-acceleration may have due to differences in state law and/or established common practices in each state.

⁸ The amount in arrears is the overdue assessment payments.

⁹ Summary of a conversation with a foreclosure attorney by Chris Lynch at Jones Hall law firm: March 17, 2010.

California

In California, state law does not permit acceleration provisions. Nevertheless, California communities have successfully raised over \$18 billion through land-secured finance district bonds in the last decade, including \$3.75 billion for special assessments like those being used to PACE finance programs in California.¹⁰ Many of California's land-secured financings have funded improvements to undeveloped properties, and some of those properties were owned by a handful of developers or even a single large developer. Some of these bonds have been sold on an unrated basis (typically when the property is undeveloped and ownership is concentrated), while others have achieved investment grade ratings (usually because the properties are developed and there is diversity of ownership). It appears that the potential negative investor impact of non-acceleration is muted by (i) the existence of debt service reserve funds and (ii) the commitment of local governments to initiate judicial foreclosure if delinquencies reach a pre-determined level, either on a per-property basis (e.g., two missed installments) or on a district-wide basis (e.g., 5% aggregate delinquency rate).

Boulder County, Colorado

In 2009, Boulder County's ClimateSmart Loan Program issued \$9.75 million in PACE assessment bonds, 70% of which were sold to local investors. PACE financing is new and Boulder County officials were concerned that investors would shy away from PACE bonds due to their lack of call protection¹¹ and lack of familiarity with how to measure the underlying credit risk and recovery value of these assessments. In Colorado, state law requires acceleration of special assessments upon property owner default. Unlike California, Colorado's local governments rely on acceleration to resolve special assessment defaults. Boulder County's program designers and their advisors believe that changing the state law by adding a non-acceleration provision, with which local investors were likely to be unfamiliar, would further disadvantage the county's bond issuance effort. *Continued on next page*

Rating agencies use a variety of criteria to assess the overall credit quality of special assessment bonds. For example, Standard & Poor's considers the method of assessment collection, value-to-debt ratios, lien position, treatment of property sales, foreclosure/bankruptcy provisions, the right to issue, term and redemption of bonds, debt service reserve, and cash flow sensitivity analyses in assessing credit quality of special assessment bonds.¹² Because rating agencies do not use a strict formula to weight the various criteria in reaching their rating decision, measuring the impact of acceleration provisions on credit ratings is difficult. Achieving an investment grade rating was important to Boulder County's effort to negotiate an affordable bond interest rate. Boulder County's financial advisor estimates that the negative impact of non-acceleration provisions would force the county to pay an additional 50 to 100 basis points of interest on PACE assessment bonds, making it more expensive to use PACE to finance energy improvements – on top of requiring a change to existing state law.

Recommendations for PACE Program Design

Many communities considering PACE programs as part of their clean energy investment strategy are located in states, like Colorado, where acceleration is required.¹³ Emerging programs in these states should be aware of both the implications of acceleration on mortgage holders and program

¹⁰ Source: California Debt and Advisory Commission.

¹¹ Call protection means that issuers may not redeem bonds for a specified period of time after issuance, typically 10 years. Call protection ensures that bond holders can benefit when interest rates fall as they are not at risk of having their high-interest rate investment redeemed if property owners pay off assessments and refinance elsewhere.

¹² From Standard & Poor's Public Finance Criteria 2007.

¹³ Consult a lawyer with expertise on your state's land-secured financing laws for further information on your program options.

participants, the implications of non-acceleration in case state enabling legislation changes acceleration provisions. Programs in states that permit or require non-acceleration should discuss the impact of non-acceleration with public finance professionals, particularly financial advisors and underwriters, and should evaluate all the options for mitigating the risk of bond defaults as a result of assessment delinquencies (e.g., through accelerated foreclosure and debt service reserve funds). Regardless of the acceleration provisions in a given state, to protect program participants, PACE bond holders, and existing mortgage holders, program designers should consider robust underwriting standards and project eligibility requirements such as those suggested in the Policy Framework for PACE Financing Programs.