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Lender Perspectives on Property Assessed Clean Energy (PACE) Loans

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Property Assessed Clean Energy ("PACE") financing is a fast-growing source of potential capital available to developers and property owners throughout the country. Available for use with both commercial properties (in which case they are typically referred to as "C-PACE" loans) and residential properties, PACE financing allows property owners to obtain generally low rate, long-term financing to help address the upfront costs of "environmentally-friendly" improvements aimed at increasing the energy efficiency of buildings. Typical projects which qualify for PACE financing include, among others, "cool" roofs, energy-efficient HVAC upgrades, lighting, insulation, windows, and even solar arrays.

Loan Characteristics

C-PACE loans are authorized by legislation at the state and local level with, at present, more than two-thirds of states having enacted legislation authorizing some form of C-PACE loans. Although the terms of C-PACE loans can differ from state-to-state, most C-PACE loan structures share the following common characteristics:

> Term: C-PACE loans are longer-term loans, generally 15 to 20 years, with some terms as long as 25 to 30 years.
>
> Recourse and Security: C-PACE loans are secured by the real property on which the subject improvements are located and are often non-recourse to the borrower. The lien of the C-PACE loan runs with the property, even after the property is transferred to a third party following a sale (including a foreclosure sale).

Lien Priority: C-PACE loan assessments have lien priority similar to real estate taxes and business-improvement district assessments and therefore have priority over both existing recorded mortgages and deeds of trust and subsequent mortgage financings.

Acceleration: PACE loans cannot be accelerated, even in the event of a missed assessment payment. In the event of a PACE loan foreclosure, only the amount of the past due assessments would be due at the time of foreclosure. The future assessments remain due and payable in the future, and the property remains encumbered by the C-PACE loan during the entire remaining term of the C-PACE loan.

Lender Considerations

In considering lending on a C-PACE-encumbered property, or consenting to the placement of a new C-PACE loan on a property that is already encumbered by a pre-existing mortgage, there are several important metrics for mortgage lenders to evaluate. Among other things, mortgage lenders should:

- obtain an independent thirty-party energy efficiency audit of the collateral property that details the expected operating cost savings due to the energy efficient improvements,
- compare expected cost savings with the assessment payments to determine a borrower’s ability to make ongoing assessment payments and what, if any effect, assessment payments will have on a borrower’s ability to timely make its debt service payments and pay the other operating expenses and carry costs of the collateral property,
- obtain an as-built appraisal to identify the potential increase in the collateral property’s value due to the energy efficient improvements and the corresponding effects on the LTV ratio, and
- consider any programmatic and/or investor requirements pertaining to super-priority liens on the collateral property.

Although C-PACE loans can reasonably result in increased property values in the long-term and lower ongoing operating costs for properties, because of the super-priority lien given to their assessments, mortgage lenders should carefully evaluate, among other things, a borrower’s ability to timely make future assessment payments. To protect its lien priority, as a condition to originating a mortgage loan which will encumber a property already encumbered by a C-PACE loan, or consenting to the placement of the C-PACE loan on the property already encumbered by its mortgage loan, lenders may wish to consider, among other things, an ongoing assessment reserve for the payment of future C-PACE loan assessments, entering into an intercreditor agreement with the C-PACE lender, or both.

Takeaway

In today's increasing interest rate environment, because of their low interest rates, C-PACE loans are likely to become more attractive to borrowers than at any time in recent memory. As such, lenders should be prepared to respond to borrower requests to allow the addition of C-PACE loans to the capital stack.

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