Lender Support Study

Enhancing the Commercial Real Estate Lender Consent Process for PACE Transactions

December 2012

PACENow
Financing Energy Efficiency

About PACE*Now*

PACE*Now* is a national non-profit corporation that serves as an impartial, fact-based advocate for property assessed clean energy (PACE) programs that promote and finance energy efficiency and on-site renewable energy upgrades to buildings. With the generous support of the Energy Foundation, Kresge Foundation, Rockefeller Brothers Fund, Tilia Fund, Johnson Controls, and others, we provide information, resources, and focus our expertise on solving challenges for a broad universe of PACE stakeholders that include state and local governments, PACE program administrators and service providers, government and trade industry organizations, financial firms, and other organizations and individuals concerned about reducing our nation's dependance on fossil fuels.

About the Author

Natalie Trojan is a Senior Director at PACE*Now.* She joined in June 2012 following a career in consulting and finance with firms such as Natixis Real Estate, BNY Capital Funding, and Deloitte & Touche. Natalie has provided strategic and financial advice and has executed billions of dollars in real estate, structured, project, and cross border financings to clients in the real estate, infrastructure, and energy sectors. Natalie is an active member of ULI – the Urban Land Institute, WX – Women Executives in Real Estate, and the Municipal Arts Society. Natalie has an AB in Architecture from Wellesley College, a Master of Regional Planning from UNC Chapel Hill, and an MBA from the Kenan-Flagler School of Business at UNC Chapel Hill.

Acknowledgments

In addition to the many real estate lending professionals who generously participated in this study, the input, observations and support of many others is greatly appreciated as well. We are indebted to Richard Chien from the GreenFinanceSF San Francisco PACE program, Dave Good from the Washington D.C. Commercial PACE Program, and Dave Hodgins from the Sustento Group, who manages the Los Angeles County PACE Program. These three cities teamed up to seek the grant funding from the Urban Sustainability Directors Network (USDN) that made this study possible. We received regular and helpful input and advice from Cisco DeVries and Kelley McKanna from Renewable Funding, and Scott Henderson of the C40 Cities Climate Leadership Group, in partnership with the Clinton Climate Initiative. We also thank Nina Albert, the former Chief of Washington, D.C.'s Office of Green Economy, who did much of the early planning and wrote the grant for this study. Jessica Bailey, formerly with the Rockefeller Brothers Fund and now Director of Commercial and Industrial PACE for Connecticut's Clean Energy Finance and Investment Authority led PACE program and Bracken Hendricks of the Center for American Progress helped us frame the project. PACE*Now*'s team included David Gabrielson and Kristina Klimovich.

List of Participating Institutions

PACENow wishes to thank the following institutions and the professionals who generously participated in the study. The findings of the study should not be attributed, necessarily, to any one participating institution or to any one particular individual within an organization, but rather to the collective knowledge of professionals in the commercial real estate finance industry.

The following 15 institutions, out of 25 interviewed, consented to have their names included in the study:

American Realty Advisors
Citibank
Comerica Bank
Eagle Bank Corp.
First Community Bank
Landesbank Hessen-Thüringen (Helaba)
New Resource Bank
People's United Bank
PNC Real Estate
Real Estate Lenders Association, Inc. (RELA)
Sovereign Bank
ULLICO
Union Bank (of California)
Wells Fargo
Westamerica Bancorporation

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I. Executive Summary

Property Assessed Clean Energy (PACE) programs initiated by state and local governments use a senior lien property tax based assessment mechanism to finance renewable and energy efficiency upgrades for buildings. Most commercial mortgages limit a borrower's ability to significantly alter the mortgaged property and encumber it with any additional debt. As a result, the majority of PACE programs targeting commercial and industrial properties require that property owners obtain the consent of their existing mortgage lender before implementing a PACE funded project. Because difficulty in obtaining consent has the potential to derail a project before it gets started, a smooth consent process is critical.

PACE*Now*, a national non-profit advocacy organization serving a broad universe of PACE stakeholders, was retained by the PACE programs in Washington, D.C., Los Angeles, and San Francisco to conduct a survey of national, regional, and local mortgage lenders whose interests in mortgaged buildings could be affected by PACE financings. Survey goals included gauging lenders' awareness and understanding of PACE, educating them, addressing their concerns, and developing insights that will enhance efforts to gain their support for individual PACE projects. This paper summarizes the findings of interviews conducted with 35 individuals representing 25 different lending institutions. Key findings and recommendations include the following:

- Surveyed lenders generally expressed no blanket opposition to PACE. Their right to consent to projects is of paramount importance to them, but they appear open to approving projects that benefit their customers and improve the value of their collateral. Lender partnership and education from the start is the key in improving probability of lender consent.
- Lenders support energy efficiency and renewable energy projects in concept, but have little firsthand experience financing them and are wary of underwriting the resulting projected savings and benefits. Education based on standard industry data and results from comparable projects is necessary to increase ease of approvals and create streamlined the processes.
- Lenders understand property taxes and assessments and factor them into underwriting models decisions. There was broad acceptance of PACE as an assessment, which limits lien exposure only to unpaid assessments, distinguishing it from a loan.
- Complexity in applications contributes to increased costs and may make some projects economically unfeasible. The size and scope of a PACE assessment should determine the degree of supporting documentation. A simple, streamlined approval process for small projects (representing less than 3% of building value) should be developed with the lender community.
- Consistency of programs across states and the nation, standardization of data sources, and creation of project related insurance policies will improve the consent process as lenders (and PACE finance providers/investors) can create national approval platforms and review projects with fewer resources.
- Existing commercial mortgage lenders have only an indirect revenue benefit from providing consent. As such, applicants have the onus of making the approval process easier for lenders until revenue streams across banks are properly aligned or existing mortgage lenders begin to provide PACE financing.

II. Introduction

a. The PACE Financing Mechanism

Property Assessed Clean Energy (PACE) uses a property tax based assessment mechanism to finance water conservation methods, energy efficiency upgrades, and renewable energy projects for buildings. Like other municipal taxes and assessments, any unpaid PACE assessments on distressed properties have a senior lien to any private debt. Because most commercial mortgages limit a borrower's ability to significantly alter the mortgaged property and encumber it with any additional debt, the majority of PACE programs targeting commercial and industrial properties, including those sponsored by Los Angeles, San Francisco, and Washington, D.C., require that property owners obtain the consent or affirmative acknowledgement[1] of their existing mortgage lender before implementing a PACE funded project. Difficulty or extensive delays in obtaining lender consent has the potential to derail a project before it gets started making an ongoing partnership with a lender critical to project success.

b. The USDN Grant

Los Angeles, San Francisco, and Washington, D.C., as Urban Sustainability Directors Network ("USDN") members, sought and received grant funding to retain and work with PACE*Now* on the Lender Consent Study (the "Study"). USDN is an organization that builds connections among its members to share and spread ideas, convene groups of members to learn about and work together on specific topics, and fund small groups of members to innovate together. The Study's goals were to develop a geographically diverse sample of national, regional and local mortgage lenders to do the following:

- Gauge their level of familiarity with PACE
- Assess their understanding of the PACE mechanism and address misconceptions
- Determine whether prior lender consent or affirmative acknowledgement is necessary or desirable
- Provide a clear and compelling rationale for approving PACE projects that meet acceptable underwriting standards
- Suggest a methodology for reviewing project applications

An important ongoing objective of PACE proponents is to build support for PACE among commercial lenders and develop a strategy for improving buy-in from the lender community. An additional goal is to conceptualize a simple, but complete lender consent application and streamlined approval process, and create a long-term partnership with a number of supportive lenders to ensure that PACE programs meet the needs of property owners and local governments, while protecting the interests of existing lenders. While the study initiated conversations with lenders on formalizing the consent process, achieving this

[1] Lender consent and lender affirmative acknowledgment are functionally the same; the difference is almost entirely semantic. Many programs have chosen to use the term affirmative acknowledgement because they felt that requiring "consent" undermines the assertion that PACE is a valid use of municipal taxation authority. Sonoma County and others felt it was necessary to clarify that they had the right levy assessments without consulting the lender, even though they required consent to avoid triggering due upon encumbrance clauses. For the purposes of this paper, all references to consent shall also mean lender acknowledgement.

goal will take time. Further work with the lender community to further build upon the relationships made, forging a systematic program with national lenders for simple, streamlined PACE approvals.

c. Methodology

Natalie Trojan is a senior director at PACE*Now* with over a decade of experience as a commercial real estate lending officer at national and international banks, who conducted the project for the duration of the grant. The project consisted of several steps, including 1) Planning, 2) Lender Interviews, 3) Data Synthesis and Initial Grant Summary, and preparing the 4) Final Report.

i. Planning

During the planning stage, discussions were held with PACE managers from Washington, DC, San Francisco, and Los Angeles to set project goals, timing, and duration. PACE*Now* created a comprehensive questionnaire with input from various stakeholders, including PACE program managers, PACE industry service providers, other NGOs, real estate lenders, and independent clean energy funders. A targeted list of real estate lending professionals was compiled, with focus on diversification on role, institution, and geographic distribution. Throughout the project, PACE*Now* held weekly calls with an advisory board to provide progress updates and to optimize the deliverables of the project for program managers. Program manager input and discussions were critical. See Appendix A for the complete questionnaire.

ii. Lender Interviews

Interviewee Profile - Interviewees included senior real estate professionals in originations, credit, risk, portfolio management, investments, and asset management, including a global head of real estate for one of the major US international banks. Specifically, almost half were originators, slightly more than 25% were credit/risk/workout officers, 16% were in energy/public finance, and 6% were portfolio managers.

Study Participant Profile, By Role In Organization	
RE Originations	47%
Credit/Risk/Workouts	28%
Portfolio Management	6%
Public Finance/Energy	16%
Appraiser	3%

The overwhelming majority of interviewees were senior decision makers for their respective institutions and had well over 10 years of experience. Interviews were conducted either in person or over the phone, in discussions that typically lasted over an hour.

Study Participant Profile, By Title	
Executive Level	13%
SVP/MD	50%
VP/Director	37%

Lending Institutions - Lending institutions ranged from local one office banks to large multinational banks, foreign and domestic. The largest category of respondents were national banks at 33%, followed by international banks at 27%, local banks at 18%, and regional banks at 15%. The remainder of the respondents was either investment fund managers or insurance company originations professionals.

Study Participant Profile, By Organization Type	
International Bank	27%
National Bank	33%
Regional Bank	15%
Local Bank	18%
Investment Fund	3%
Insurance Company	3%

Geographic Distribution - Geographically, the majority of respondents were from New York and California. Also included in the survey were real estate professionals from Colorado, Connecticut, Florida, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, Ohio, and the District of Columbia. For details, please see the accompanying chart.

Familiarity with PACE - There was a broad range in the level of pre-existing awareness and understanding of PACE. Most of the respondents had no direct experience with a PACE project, but their hypothetical considerations seemed consistent with those of the few lenders who had reviewed (and approved) PACE projects. The results of more than 35 interviews with over 24 financial institutions are summarized in this paper.

Challenges with setting up Interviews – Given the political and economic pressures faced by banks in recent years, many bankers were reluctant to participate in the survey due to time pressures and publicity concerns. Some lenders were hesitant to offer their firm's views on PACE, but rather agreed to provide responses based upon years of experience in the real estate finance industry. To encourage participation and candor, all respondents were assured confidentiality so that their specific answers would not be tied either to them or their institution.

iii. Data Synthesis/Preliminary Grant Summary

Upon completion of the interview process, data was compiled and analyzed by PACE*Now*. A preliminary summary was prepared and circulated amongst the USDN grant advisory group. In addition, a summary of findings was also presented at a meeting sponsored by the Rockefeller Brothers Fund, PACE*Now*, and the Center for American Progress in September. Participants included PACE professionals from all aspects of the program, including PACE*Now* funders, PACE program officers from around the country, environmental and mechanical engineers, corporate sustainability officers, and real estate lenders. The preliminary grant summary was also shared with the USDN in conjunction with their annual conference in October. The preliminary report was well received and comments have been incorporated into this final report.

iv. Final Written Report

This final report is intended to help PACE program managers enhance the PACE lender consent and financing processes. It includes study findings and recommendations that could create a smoother, quicker, and more streamlined PACE consent process. PACE*Now* and USDN grant participants intend to continue outreach with the commercial real estate lender community initiated under this USDN grant will continue after the completion of the final report.

III. Study Findings

Thirty-five personal interviews were conducted over the course of four months. Overall, reactions to PACE were fairly positive. Only one interviewee seemed categorically opposed to approving any PACE project. All others indicated an interest in achieving PACE program goals and a willingness to explore ways to approve projects. Interviewees viewed energy efficiency and sustainability in commercial properties as an evolving but important part of the future of real estate. Currently, Class A properties at the top end of the real estate market see buyers and tenants who are demanding sustainably built-out spaces. It is expected that this trend will trickle down through Class B and Class C properties.

a. Support for and Familiarity with PACE

Lenders are generally supportive of PACE, but for most, support is on a theoretical basis due to a lack of first hand PACE project evaluation. Almost all lenders indicated support and interest in PACE as a way to finance energy efficient improvements. However, familiarity with PACE was generally lacking. While the survey attempted to target a wide variety of respondents based upon their knowledge and familiarity with PACE, finding lenders who were knowledgeable in PACE program attributes was challenging. Fifteen of the thirty-five interviewees had no prior knowledge of PACE, while the remainder had a good to excellent understanding of PACE due to their interest in energy efficiency or involvement in the approval of a PACE assessment on one or more of their mortgaged properties. This sample was deliberately skewed to provide a diversified sample. It is not representative, however, of the general commercial real estate community, which generally has little to no knowledge of PACE at this time.

b. Experience with Energy Efficiency

Most real estate lenders interviewed have had little or no experience with any kind of energy efficiency lending. Some had limited familiarity with sustainable buildings, mostly related to financing projects which may include a LEED component. In a LEED project, lenders are aware that one aspect of the building is its sustainable elements but the LEED factor is evaluated in the context of a larger, complex financing decision for the entire project. Furthermore, while lenders agree that an energy efficient building is generally desirable and more cost effective, few if any, are prepared to give automatic or standardized credit to specific energy efficiency measures during the underwriting process. As one lender put it (regarding energy efficiency), “it’s nice to have, but it doesn’t get it through credit approval.” There is a clear lack of knowledge about how to evaluate the appropriateness or effectiveness of proposed energy efficiency measures.

c. Framework for PACE Project Review

Mortgage lenders are familiar with property taxes and assessments and factor them into lending decisions all the time. Lenders know that property taxes can (often dramatically) increase and new assessments can be imposed (without their consent). As is the case with a PACE assessment, taxes and assessments remain with a building upon sale, whereupon only unpaid assessments in arrears (if any) must be satisfied to affect the transfer of a building. Thus, the PACE assessment concept is easily understood and evaluation is simple as lenders regularly incorporate assessments into cash flow analyses and know how to value them.

d. Views on Consent

Not surprisingly, lenders unanimously agree that the right to consent or acknowledge a mortgagor's ability to encumber the property with an assessment is critical, since the PACE encumbrance is voluntarily entered into by the property owner. Lenders view consent as explicit written acknowledgement before an assessment is placed on a property. The absence of an open dialogue regarding consent between banker and borrower violates not only trust, but in many cases also violates loan covenants regarding placement of liens on the property without the lender's consent. As one Senior Vice President of originations put it, "it's all about trust and working together, if we're not talking (with the borrower), then we have a bigger problem."

Furthermore, many bankers and loan documents stipulate the necessity of notice regarding any alterations to the property during the loan period. Unforeseen problems during construction may pose large financial losses if the building becomes uninhabitable or cannot be leased for any time. Many loan documents require reserves and guarantees for alterations, completion guarantees, and escrow of tax/assessment payments. In cases where taxes are escrowed for the term of the loan, lenders may also require an upfront escrow of PACE assessment payments during the remaining loan term.

e. Regulatory Concerns

Lenders in the sample group seem largely unconcerned about adverse reactions of regulators as a result of approving PACE projects. Because modifications to loans, regardless of size or scope, typically require credit committee approval or adherence to established credit underwriting protocols, a PACE assessment would be subject to approval using standards that meet regulatory guidelines. With a credit approval for the PACE assessment, the assessment then falls within the bank's credit parameters and is considered within accepted risk criteria. Eventually, project flow at scale may allow lenders to establish a more streamlined approval process, and it is likely that any such standardized approval procedure would be vetted with regulators prior to adoption. Provided that lenders have a right to consent, fear that approval of projects will be withheld due to regulatory concerns, or that regulators will intervene to halt commercial PACE programs seem unfounded.

f. Credit Process and Factors

"It's all about the cash flow" for commercial real estate lenders. This sentiment was echoed by almost all interviewees, large and small, local and international. If a proposed project saves money, increases net operating income (NOI), increases building value, and fits within the lender's underwriting parameters for loans metrics, such as loan to value (LTV) or debt service coverage (DSCR) ratio, then the proposed PACE project will likely obtain consent. Lenders also prefer to see a PACE assessment result in positive cash flow upon implementation and an assessment term that generally does not exceed the useful life of the improvements. The proposed improvements also have to be appropriate for an individual property, so that a property is not "over-improved."

A second, but very important factor is the relationship with the borrower. A strong borrower, with multiple profitable relationships with the bank, will more likely get the support of a lender for a PACE assessment as long as the PACE assessment does not put the borrower over the limit for overall credit exposure to an individual customer.

Third, while bankers may talk about their institution being committed to being "green" and supporting energy efficiency, more often than not, they are referring to their internal corporate practices for their own corporate properties rather than to their revenue generating business lines. It is important to understand this distinction to avoid misconceptions related to an institution's actual lending practices.

g. Standardization

Standardization of the application process was cited as a key concern to allow for future increased volume of projects to approve. Currently, each project is approved on an individual basis in often a time consuming and individualized process. Since approvals are generally done at the branch level, often with little knowledge of the head office, there is no standardized approval process in larger banks at this time. A bi-furcation of the approval process into small and large projects appears to be recommended to simplify approvals. Small PACE projects in terms of dollar amounts and percent of property value should have a quick and standardized process, while larger, more significant projects would be subject to a full underwriting and credit approval procedure as they would have general characteristics of a construction loan.

h. Additional Findings Specific to Consenting Lenders

While the previous findings were generally common to most interviewees, additional data from lenders who had provided approvals for PACE assessments is provided below:

i. Projects that have received lender consent for PACE projects thus far have generally (with one or two exceptions) been very small relative to the building value or mortgage amount at 1% to 3% of the property value. At these levels, the PACE assessment is deemed "insignificant" to the overall risk of the mortgage. Such "insignificance" made the approval process easier.

ii. Approvals focused on the economics of the project but were often closely tied to the client's overall relationship with the bank. A good client may get PACE approval, while a marginal client may not, for the same project economics and same LTV or DSCR.

iii. Follow-up on energy efficiency performance is generally lacking on the part of both PACE programs and consenting lien holders. As a result, there is little data on the efficacy of PACE measures. Measurement of performance data on efficiency and PACE project performance is key to get buy-in from lenders in the long term.

iv. Compliance with assessment payments was easy to verify simply by viewing the tax statement.

v. Lenders that were interested in financing more energy efficiency projects or PACE assessments were frustrated with the lack of deal flow due in part to a shaky economy, despite some healthy subsidy enhancements.

IV. Recommendations

a. Education

Lender education on all levels is vital! Lenders are open to new products and ideas that have the potential to enhance the value of their underlying collateral. However, sophistication in terms of understanding and valuing energy related projects was severely lacking among interviewees. From a lender's perspective, the simplest analysis is to ignore any potential benefit from a project and measure only the effect on DSCR from PACE assessment payments. Of course, this approach also makes it harder to meet underwriting standards for project approval as the benefits of improvements are ignored. Part of the PACE message has always been that a PACE assessment is unique among municipal assessments; most add to the cost of a building whereas a PACE assessment reduces costs. Recommendations for education include the following:

i. PACE program managers should pro-actively educate the commercial real estate community regarding the structure and goals of the PACE program. When seeking consent on a project, program managers should seek the cooperation of mortgage lenders early on in the process to ensure a spirit of cooperation and make it more likely that consent for PACE projects is received. It is important to stress to lenders that the worst case scenario is that one year of payments is due, while the upside is enhanced collateral value and functionality.

ii. Clearly present that PACE financing is an assessment and not a loan. This approach is both accurate and beneficial, because it allows lenders to review projects in an existing underwriting framework and allays the concerns they would have with a loan, senior to theirs, that would need to be paid in full with proceeds from the building's sale.

iii. Provide empirical and practical benefits of energy efficiency to lenders upfront with references to industry databases or 3rd party reports. Data needed includes costs, expected savings, and payback periods for particular improvements on a per unit or per square foot basis. A database of the performance of improved properties is also desirable so that underwriters can have comparable historical data to reference. To the extent it is lacking, creation (or identification) of an industry accepted database or professional resource for information regarding improvement measures and their expected financial effect is critical to gaining wider usage and acceptance.

iv. As a long term goal and as previously noted, work to convince lenders that PACE project will result in energy savings. Savings that exceed the additional assessment cost lead directly to higher operating income and an increase in building value that will exceed the total assessment amount, providing a strong rationale for lenders to provide consent. Specific project data savings could be prepared and presented in a written memo to improve lenders' understanding and incorporation of anticipated project savings into their underwriting analyses.

v. Explain that PACE may be practical for under-performing properties. Property owners that are under-water have used PACE to make necessary repairs and successfully improve property economics when their existing lender is unwilling or unable to lend more money for the project. Lenders are best convinced by cash flow projects that PACE can improve property economics even with the addition of the PACE assessment payment.

b. Best Practices in Gaining Lender Consent

Currently, each PACE project will likely be treated as an amendment to an existing credit facility and will be subjected to the same underwriting standards and approvals necessary under established credit procedure that conform to existing regulatory guidelines. For all lenders, "It's always about the cash flow. Then, it's about the customer." A good customer has the power to get PACE consideration, but the project always has to make sense first.

Best practices for gaining lender consent include the following:

i. Approach the project owner's bank relationship manager (also known as the commercial real estate lender) when seeking PACE consent. This lender typically would have originated the senior mortgage loan. After gathering necessary data, the lender will prepare a credit memorandum summarizing the PACE project and its impact on mortgage repayment. Depending on the institution, the complexity of the PACE project, and the size of the overall borrower's relationship with the bank, the lender will seek approval in one of two ways. The first option is that the credit memo will be discussed in a credit committee meeting of senior bank officers, including credit and risk officers who will decide jointly whether to approve or deny the relationship manager's request. The second option is that the credit memo will be submitted up a chain of progressively more responsible officers for individual approval. In almost all cases, credit approval is from more than one bank officer and written rationalization is required for regulatory reasons. The time required for approval varies greatly by institution and can range from a day to six months. Smaller institutions tend to more nimble and provide faster execution, while larger national banks typically take more time often because of multiple reviewers.

ii. Start with the assumption that most commercial real estate lenders have little knowledge of energy efficiency projects and their benefits. Also, assume that despite the potential benefits to a lender's property from energy efficiency improvements, lenders have little time and (at this point) little interest in researching the benefit of proposed savings measures. From a lender's perspective, time spent pursuing new financings will have a higher impact on bank revenue than providing consent on an existing mortgage (unless the lender is also funding the assessment). Thus, it is the applicant's job to provide sufficient documentation for the lender to make an informed decision. The overall relationship between a borrower and their lender will likely influence a lender's consent decision.

iii. Create an educational program or informational marketing materials suited for the local commercial real estate lender community. Specifically, educate lenders on the mechanics and benefits of PACE. To the extent possible, hold informational meetings with key PACE advocates to promote the PACE program. Create a list of preferred, high-quality contractors that bankers can trust so as to minimize construction risk.

iv. Give the consenting lender with a written summary of the PACE program, mechanics, and specifics that outline proposed project costs and benefits, including the impact on NOI after payment of additional assessments. Lenders like to have backup for their underwriting and credit committee submissions.

v. Provide copies of any third party reports which outline project goals, costs, savings, and anticipated payback periods. If available, provide references to industry databases for energy efficiency data. Data should be provided on a per square foot or per unit basis to the extent possible.

vi. Maintain detailed data on PACE projects completed in the program. Metrics interesting for lenders include anticipated vs. actual energy savings, anticipated vs. actual dollar savings, benefit to NOI, payback periods, financing costs, financing rates, default rates, and number of projects with PACE financings. Note that most lenders will not provide consent for projects when LTV exceeds 80% or DSCR is less than 1.2x for performing properties. Stricter standards apply to less desirable property types like hotels. To enhance performance data, program managers across the country would be well advised to contribute to a national PACE project database that PACE*Now* is developing, in part to provide comfort to lenders on key project metrics.

vii. Stress that the worst case scenario for consenting lenders is that only the payment of assessments in arrears, plus penalties and interest would be due in a default. If PACE projects can be demonstrably shown to improve a buildings NOI (and therefore, its value), then loss exposure will be more than offset by an increase in the collateral value of the building. In addition, program managers should be ready to explain mechanics of the PACE assessment in the event of a default to allay fears of penalties, losses, and liabilities of lenders.

viii. PACE projects without lender consent may cause unwanted friction between a lender and the borrower. An alternative would be to pursue property re-financing with a new lender that is friendly to PACE. By incorporating PACE into the new financing structure, PACE can enhance the structuring flexibility of the new mortgage lender by providing for A/B capital stack structures and greater rate flexibility.

ix. Standardize programs to the greatest extent possible as described below.

c. Standardization

PACE program managers should coordinate to create a uniform set of PACE standards. PACE will gain popularity and lender support through product predictability and consistency across programs and states. Consistency will make approvals easier as banks can then create national, state, or bank wide program standards for providing PACE consent. With a streamlined approval process, lenders are more likely to agree to consent and will be able to provide it faster and using few resources to do it. Consistency will also make is easier for PACE assessments to be pooled, securitized, or sold as investment products. Without this liquid market for PACE assessments, interest rates will likely remain high because few investors will be interested in holding one-off PACE assessments for 10 to 20 years. However, project volume is needed before banks will spend the time to standardize policies or procedures at a state or regional level.

Among lenders, at this point, there is no standardized way of evaluating a PACE project. All approvals to date have been done on a one-off, generally time consuming basis. Anecdotally, some building owners are reluctant to consider PACE financing for projects because they fear that lender approval will not be forthcoming. In the case of national banks, approvals have often been provided at the branch level without the knowledge of the head office. Approvals vary from branch to branch and state to state. To improve the speed and predictability of the approval process, conversations with lenders point to the desirability of creating two approval paths, as described below.

- Simple improvement projects which are small in scope, use standard technology, and are relatively “insignificant” in size to the total value of the property would be best suited to a standardized consent process. Such project applications should be uniform and include a completed project scope, a project proposal with costs and timeline from pre-qualified contractors, estimates of cost savings and payback for the investment, and an analysis of the total impact on NOI of the improvements on the project performance. Some programs may include a Level I ASHRAE report or other 3rd party engineer recommendations/energy audit. Over time, banks should be able to create "black boxes" that would streamline the application process making approval relatively perfunctory.

- Complex projects that have the potential to affect the usage of the building, use new or sophisticated technology or impact multiple building systems, have high dollar values, and lengthier implementation periods will continue to be done on a one-off basis. Each such project application would be unique, as it would be akin to a construction project requiring engineering plans, ASHRAE Level 2 or 3 reports, consulting engineers, construction oversight, set up of reserves and contingencies, and supporting legal documentation. Standardization of such projects seems unlikely in the near term due to the high dollar values (starting at $500,000 but more likely at the $1 million value and up) and due diligence required before and after the project.

V. Conclusions

The following are conclusions of the study:

a. Senior mortgage lenders strongly believe that a PACE project must receive lender consent before the PACE assessment is attached to the property. It is about trust and the relationship between the lender and the borrower. Without a trusting relationship, the borrower-lender relationship is in trouble and any future activity will be negatively affected. Furthermore, in some cases, the mortgage documents require a borrower to get lender approval for any alterations to or any new liens on the collateral.

b. The absolute and relative size of the assessment is important. Lenders readily provide approval for projects which are small or inconsequential relative to the overall value of the property or the mortgaged portion of the property. Minor projects are characterized as those not exceeding 1% to 3% of the building value or loan amount. Once projects tend toward the 5% range, they start gaining more significance and begin being subjected to additional scrutiny. Projects between 5% and 10% of the building value or loan amount are more significant and are subject to additional lender analysis, which may include third party appraisals, engineering, or construction consultant reports. Projects exceeding 10% of the building value typically major construction projects and are subject to the same analysis and requirements, such as completion guarantees, reserve requirements, construction consultants, etc. Such projects may compete with a lenders' construction financing.

c. To ensure solid underwriting and full consideration of the cash flow benefits of conservation and energy efficiency measures, lenders need an industry accepted database that provides estimated savings, payback periods, and expected useful lives of a variety of measures on a per unit, per square foot basis. Such a resource would provide a useful benchmark against which future projects may be evaluated. Additional research in this area is warranted.

d. Cost effective insurance for performance or energy savings could make the PACE project approval process easier, but would not eliminate all lender concerns. Insurance would provide an independent third party evaluation of the efficacy of proposed efficiency measures, which would be beneficial. However, the insurance provider underwriting projected savings would need to be highly rated. This would not only provide assurance of savings but would provide an independent third party source for evaluation the efficacy of proposed efficiency measures. Lenders will also pay close attention to the many caveats that protect insurers from outcomes beyond their control, such as variations in weather, usage of the building, and correct maintenance of systems and equipment.

e. PACE programs need to be aware of excessive transaction costs. Obtaining legal counsel, appraisals, and consultant reports is expensive and may exceed financial benefits in small transactions. Creating standardized program parameters for small transactions is key to building and sustaining deal flow. For larger transactions, costs are also an issue but are generally more sustainable due to the transaction size.

f. PACE will gain popularity and lender support through product predictability and consistency across programs and states. Consistency will enable banks to create national or bank wide program standards for providing PACE consent. With a streamlined approval process, lenders are more likely to agree to consent and will be able to provide it faster and using few resources to do it. Consistency will also make is easier for PACE assessments to be pooled, securitized, or sold as investment products. Without this liquid tradable market for PACE products, interest rates will likely remain high and few investors will be found that will be interested in holding illiquid 10 to 20 year debt.

g. Many bankers struggle with “what in it for them?” While many readily acknowledge that PACE funded improvements will likely positively impact the value of their collateral, thereby improving loans metrics, bankers think in terms of revenue to their business unit. Providing PACE approvals is not a profit generating business, but funding PACE assessments can be very profitable. Because real estate bankers have traditionally not underwritten small scale 10 or 20 year fixed rate term financing (as provided under PACE), financing for PACE assessments may come from other areas of a bank. The challenge, particularly for institutions interested in PACE funding, is to bridge the approval and funding departments so that their financial interests are aligned.

VI. Further Research

Continued outreach to lenders is an important strategic objective for PACE*Now*. Though the grant period is ended, we will continue with efforts to educate mortgage lenders and strive to develop streamlined procedures for project approval. Several possibilities for continuing PACE*Now's* efforts include, but are not limited to the following:

a. Work with a key group of lenders to create a standardized, simplified PACE approval process.

b. Work with program managers to help create a PACE project database.

c. Continue to educate commercial real estate lenders through educational programs and out-reach.

d. Work with program managers to develop an energy efficiency database for commonly implemented energy efficiency measures.

e. Partner with industry organizations, such as the Urban Land Institute (ULI), the U.S Green Building Council, and BOMA to promote the PACE program.

VII. Appendix

a. PACE*Now* Questionnaire used for the Survey

Familiarity with PACE

1. What is your overall familiarity with PACE?
2. A bit about yourself
    - What business group are you in?
    - What is your reporting line?
    - What is your title and role?
3. Have you had direct experience with a PACE project?
    - Have you been asked to review a PACE project?
    - What was the outcome of that review?
    - Have you or your institution considered creating a PACE program?
    - What business group(s) in your institution are responsible for evaluating PACE?

Experience with EE projects generally

1. Do you or your institution finance EE projects?
    - How (types of loans / terms)?
    - What group(s) handle this business line?
2. Does your institution view EE as an attractive business opportunity? Is your institution still evaluating whether to pursue the EE market?
3. How often have you been asked by owners, contractors, others to consider financing non-residential private building EE projects?

Credit review process at the bank

1. Does the institution typically require a review of its approval for standard EE measure funding requests?
    - Is there a de minimis threshold that does not require approval?
    - Does it depend on the measure (e.g. boiler, windows, chiller plant, and solar panels)?
2. Does the dollar amount factor in the level of review (i.e. would smaller projects routinely reviewed at a lower or branch level?
3. Is this a committee decision or one person's? Is it at the local level or global institutional level?
4. How long do reviews/approvals typically take?
5. What is the role of the local (or relationship) manager?

Credit Factors / Building Business Factors

1. Current LTV?
2. NOI pre project vs. post project?
3. Building's current DSCR? Future DSCR?
4. PACE amount relative to building cost or value?
    - If so, how is the value determined? Internal valuation, external appraisal, property tax assessment, or NOI/CAP rate?

5. Are other assessments included in evaluation of a building's outstanding debt load?
    - Given the non-acceleration feature of a PACE assessment, is there a rationale for treating a PACE assessment differently?
6. Does your institution see added value in a building that is more energy efficient?
    - Given tenant preferences / willingness to pay higher rents?
    - Given possible energy disclosure requirements?
7. What types of economic models does that institution rely on upon to evaluate EE measures? Models that reflect:
    - National economic trends or regional / local economic trends?
    - Building specific data?
8. What types of data and sources does the institution rely upon to evaluate EE measures?
    a. If none are used currently, what data and sources would be deemed acceptable for reliability/benchmark calculations?
9. To what extent would project savings guarantees by a third party assessors or insurance providers mitigate concerns?
10. What other credit factors should PACE programs be considering?

Regulatory Concerns

1. Does the institution have a regulator? If so, who is it?
2. Has the institution discussed PACE assessments with its regulator?
    a. Why or why not?
    b. If so, what has been the feedback?

Other Factors/Concerns

1. Is right of first refusal (to participate in the PACE financing) an attractive opportunity?
2. Would an inter-creditor agreement with PACE investors allay concerns surrounding delinquency/default?
3. If the institution chose to finance a PACE assessment, how long a term of financing could it provide?
4. How would the decision to fund a PACE assessment be tied to the ownership of the senior debt on the property?
5. How would the institution think about pricing a PACE assessment, relative to other debt on the property?
6. Are there concerns about downstream disposition of the existing loan, including a sale or securitization?
7. Are there incentives to you as a financial institution that could factor into these concerns? CRA credit applicability? Positive publicity?

Standardization

1. Is there any willingness to discuss broad parameters for originating projects and streamlining PACE approvals?
    - What factors, in general would result in an approval?
    - What factors would make a building ineligible almost immediately?
2. What standards would help in making the approval process streamlined?

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