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Expert Analysis

How New York City Is Picking Up the 'PACE'

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On May 19, 2019, the New York City Council passed a series of groundbreaking bills collectively referred to as the Climate Mobilization Act or the "CMA." The goal of the CMA is to reduce New York City greenhouse gas emissions 80% by year 2050. The bills passed were designed to achieve this lofty goal in part by placing a statutory cap on greenhouse gas emissions, requiring green roofs, and making it easier to build large wind turbines. One of the most significant CMA bills was Int. 1252-A, now known as Local Law 96 of 2019, enabling Property Assessed Clean Energy (PACE) financing in New York City for the first time. Although PACE programs are available for both residential and commercial properties, this article will focus on commercial PACE financing.

PACE financing is an innovative method of financing that enables property owners to obtain funding for certain eligible energy efficient building improvements often referred to as "qualified improvements." Common examples of eligible qualified improvements are new HVAC systems, new doors and windows, lighting, insulation, and solar panels. Borrowers (owners) are able to obtain 100% financing of the cost of Qualified Improvements, which is amortized over the course of the useful life of the Qualified Improvement, at a fixed competitive interest rate.

As PACE increases its jurisdictional reach and gains popularity, lenders are becoming increasingly familiar and comfortable with PACE financing.

The hallmark of a PACE loan is how it is secured and repaid: a PACE loan is secured by a special real estate tax assessment on the property upon which the qualified improvements are being made and is thus repaid through the normal course of real estate tax payments. This security and repayment structure makes PACE unique to other types of loans. The priority of the PACE assessment is analogous to the priority of a sidewalk or sewer assessment and like these and other special assessments, a PACE assessment is senior to any mortgages also encumbering the property.

Mechanics of a PACE loan

PACE financing is not available everywhere. PACE enabling legislation is required in the taxing jurisdiction in which the owner seeks PACE financing and it establishes the framework for how the PACE program will work in that particular jurisdiction. As of this writing, more than 35 states and Washington D.C. have passed PACE enabling legislation. PACE enabling legislation had previously been enacted in the state of New York but was not enacted in the City of New York until earlier this year as part of the CMA.

Although PACE financing is paid back through a special real estate tax assessment, private lenders are the ultimate providers of funding for the project and these private lenders become the PACE provider. The PACE provider guides the property owner through the PACE process (including the evaluation of Qualified Improvements) and acts as a liaison between the property owner and the local PACE authority. The PACE provider also provides the technical assistance needed to underwrite the energy savings that the proposed qualified improvements will generate. This helps to determine

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the amount of PACE financing that will be available to the borrower.

Borrower Advantages

In order to achieve its goal of reducing greenhouse gas emissions 80% by 2050 as envisioned by the CMA, the PACE legislation seeks to provide owners an affordable way to achieve that goal and thereby comply with Local Law 97 of 2019—which requires owners of large buildings to reduce their carbon footprint starting in 2024. PACE financing may be attractive for many reasons. First, no personal guaranties are required because PACE financing that is based solely on the value of the asset and not the credit of the sponsor. Second, interest rates are competitive long term fixed interest rates (typical rates are currently between 5.5%-6.5%).

Also, unlike traditional construction financing for new improvements, PACE enables a property owner to borrow 100% of the cost of the qualified improvements. This immediately provides the borrower a substantial loan savings and drives down the over-all blended cost of construction capital for a project. For example, the traditional capital stack for a construction project might be sixty percent funded by a mortgage construction loan, 20% funded by a mezzanine construction loan and the remaining 20% funded by equity. In this example, it can be expected that the interest rate on the mezzanine financing would be approximately 12%. If all or part of the mezzanine financing is replaced with a PACE loan at a fixed rate of approximately 6%, it is obvious that the overall cost of capital for the construction of the project is significantly reduced.

One other significant advantage of PACE financing is the term of the loan. Traditional construction financing is short term and must be refinanced shortly after completion of the project. PACE financing fully amortizes over the useful life of the qualified improvements which are typically from 20 to 30 years. This eliminates the need to refinance that portion of the construction financing and saves the requisite refinancing costs of doing so (such as origination fees, legal fees, etc.). Moreover, in addition to saving on financing costs, the owner of the property will also realize savings in energy costs attributed to the installation of the qualified improvements. Finally, because the PACE financing attaches to the property and not the owner, it is fully assumable by successor owners and the loan does not accelerate as a result of the sale.

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Lender Hesitation

Despite the cost effective attributes that may make PACE financing an attractive option to borrowers, PACE loans have historically been unwelcome and resisted by mortgage lenders due to the PACE loan's security priority. Because PACE financing is a special real estate tax assessment on the borrower's tax bill, it is superior to any other debt on the property. Of course, mortgage lenders are accustomed to holding a first lien position subject to only property taxes. The special real estate tax assessment of the PACE financing is treated akin to a real estate tax and thus primes the mortgage loan. For this reason, mortgage lenders have pushed back against PACE, with some expressly prohibiting PACE financing in their loan documents.

This resistance in the mortgage lender industry has prompted most PACE legislation to require that the property owner obtain the prior written consent of the mortgage lender to any PACE loan. Additionally, some PACE financing documents require the borrower to expressly acknowledge that even if their mortgage lender consents to the PACE loan, future mortgage lenders may not consent, which may cause liquidity issues for owner in the future when it seeks to refinance their mortgage loan. That said, the receptiveness to PACE loans in the capital markets is changing.

In spite of the mortgage industry's resistance to PACE financing, an increasing number of institutional mortgage lenders have started accepting PACE financing and permitted PACE liens to prime their lien. As PACE increases its jurisdictional reach and gains popularity, lenders are becoming increasingly familiar and comfortable with PACE financing. Lenders also recognize that the real estate industry is heading more and more towards green infrastructure in both the retrofitting of existing buildings and new construction. Legislation like the CMA will make this more of a reality and continue to create more and more demand for the financing of green construction. Accordingly, lenders that continue to be wary of PACE may find themselves at a competitive disadvantage to the growing roster of lenders that do permit PACE financing. This may especially become truer now that PACE has been enacted in the City of New York.