

ABS Research

PACE Regulatory Roadmap -- California Laws Promote Consumer Protections

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Morningstar Perspective

As property assessed clean energy programs have expanded across the U.S., the industry has come under increasing scrutiny regarding consumer protections. California, the location of PACE's birthplace, is the first state to pass legislation aimed at increasing consumer protections. Morningstar Credit Ratings, LLC believes that the California measures, which include regulatory oversight through an independent agency, improved underwriting guidelines based on a property owner's ability to pay, and prohibitions of activities that might lead to a conflict of interest, will collectively strengthen underwriting practices.

Gov. Jerry Brown signed into law both Assembly Bill 1284 and Senate Bill 242 on Oct. 4, 2017. Even though the new legislation is specific to California, Morningstar would not be surprised to see program administrators adopt these new measures on a nationwide basis, as California is a leading PACE market. We also view most of the requirements as a credit positive for future securitized residential PACE assessments. In the appendix, we have provided a snapshot of the credit impact on the key provisions contained in the two California bills. However, California is not done with revising PACE legislation, as there are three other bills that were introduced in the state's Assembly and Senate this month to provide more clarity and promote further data transparency.

Federal Level

Before examining California's recent legislation, we note there are two bills in the works at the federal level. In November, Sen. Mike Crapo of Idaho introduced the Economic Growth, Regulatory Relief, and Consumer Protection Act. This bill would empower the Consumer Financial Protection Bureau to study PACE credit transactions and possibly include PACE assessments under certain regulations related to the Truth in Lending Act of 1968. The bill has garnered support, and the Committee on Banking, Housing, and Urban Affairs held hearings in January. The bill is on the Senate Legislative calendar for consideration. In April, Sen. Tom Cotton of

Arkansas introduced the Protecting Americans from Credit Entanglements Act of 2017, which includes PACE assessments under certain provisions of the Truth in Lending Act, but the bill appears to have stalled.

California Regulatory Oversight

While AB 1284 and SB 242 both introduce numerous requirements intended to strengthen consumer protections and improve overall business practices, Morningstar identifies regulatory oversight as a major development. The new legislation gives the California Department of Business Oversight the authority to regulate PACE program administrators. Having an agency that can bring enforcement actions against program administrators will help reinforce good business practices. Beginning Jan. 1, 2019, the department will issue licenses to program administrators, which will have to comply with similar requirements to those of California finance lenders. In addition, program administrators will be required to submit semiannual reports, including methodologies, assumptions, volume, delinquencies, missed payments, and defaults. The collection of this discrete assessment information will, for the first time, offer data transparency for the investor community and help identify important credit trends. Over time, we would expect to use the historical data as a basis to help us formulate our credit assumptions.

Improved Underwriting Guidelines and Disclosure

Evaluating a property owner's ability to pay is another key measure. The Department of Business Oversight will determine the metrics to measure a property owner's ability to pay, which may include income, assets, and current debt obligations, whereas current eligibility is largely based on home equity. This more vigorous examination of a property owner's ability to pay commences on April 1, 2018, and will likely lead to a lengthier underwriting and approval process or possibly even a decline in origination volume as fewer property owners will qualify. A complete financial profile will be collected from the property owner and will include all secured and unsecured debt, ranging from alimony, child support, and monthly housing expenses. Full disclosure of outstanding obligations and the more vigorous screening process will result in a better assessment of a property owner's ability to meet the PACE obligation.

In addition, the program administrator shall obtain oral confirmation regarding whether the property owner has received or is seeking additional PACE assessments before a property owner executes an assessment contract. This is an important disclosure as a property owner currently has no statutory obligation to reveal other outstanding or intended PACE obligations. On the residential side, such disclosures will help program administrators more accurately assess a property owner's ability to pay the PACE obligation. It's important to note, however, that this is less relevant concerning commercial PACE because a property owner usually obtains the consent of the lender before engaging in a PACE assessment.

AB 1284

Morningstar believes many of the new requirements introduced in AB 1284 are credit positive. Some requirements commence on April 1, 2018, and others begin on Jan. 1, 2019. The most significant of them are the following:

- **Regulatory Oversight** – The California Department of Business Oversight will issue licenses to program administrators starting Jan. 1, 2019. In addition, program administrators will be required to file an annual report. This will incentivize stronger business practices.
- **Improved Underwriting Standards** – Commencing April 1, 2018, the most accurate automated valuation models will be used to value the property. In addition, program administrators are also required to evaluate specific underwriting criteria and must incorporate a property owner's debt obligations when determining the owner's ability to pay. This includes all secured and unsecured debt, alimony, child support, and monthly housing expenses. The financing must be for less than 15% of the property's value, up to the first \$700,000, including any existing assessments. For properties valued above \$700,000, the financing will include the 15% rule, but it drops to less than 10% for the remaining value of the property above the \$700,000 threshold. Finally, total PACE assessments and mortgage-related debt on the property will not exceed 97% of the property's market value. These new guidelines should result in better assessment quality.
- **Assessment Contract Criteria** – Certain checks, such as ensuring all property taxes are current and financing limits are upheld, must be met before a program administrator approves an assessment contract. These checks help to promote higher quality underwriting.
- **Background Checks** – PACE providers will have to go through background checks and satisfy net worth requirements to get a license. This higher level of scrutiny and minimum financial requirements will help improve the quality of the PACE provider.
- **PACE Registry** – Program administrators may be required to use a real-time registry or database system for tracking PACE assessments. No later than Jan. 1, 2020, the commissioner of the Department of Business Oversight shall determine whether to proceed with a rulemaking action to require this change. If implemented, this will increase transparency and allow for the collection of data for performance metrics.
- **Minimum Training Requirements for Contractors** – Program administrators must train home improvement contractors and their respective salespeople. Major program administrators already have such measures, but the requirement will be good for the smaller players who do not have formalized programs. Establishing these minimum training requirements across the industry will not only help promote a higher level of expertise, but also it will help avoid misrepresentation by these parties.

SB 242

Like AB 1284, many of the requirements in SB 242 are positive for the quality of future PACE assessments:

- **Oversight** – A program administrator must submit semiannual reports to the respective city or municipality for each PACE program. Information includes methodologies, assumptions, volume, and assessment information, such as delinquencies, missed payments, and defaults. This allows for more transparency and collection of data for performance metrics.
- **Required Phone Confirmation of Key Terms** - The program administrator must make a verbal confirmation of the key terms. The phone calls supplement the required written disclosure of full PACE terms. This practice helps to ensure that the property owner has a full understanding of the terms, which promotes higher assessment quality.
- **Property Owner Disclosure** – A program administrator shall get oral confirmation about whether the property owner has received or is seeking additional PACE assessments. Because this practice determines whether existing PACE assessments are outstanding, cash flow analysis is improved.
- **No First Payment Deferrals** – A program administrator cannot waive or defer the first payment, and a property owner’s first assessment payment is due no later than a year after the installation of the efficiency improvement is completed. This promotes timely payments.
- **Suitability/Right to Cancel** –A property owner can cancel the contractual assessment at any time before midnight on the third business day. This consumer advocacy measure helps to promote owner suitability and a full understanding of the terms.
- **Limited Conflict of Interest Advertising** – A contractor or other third party cannot advertise the availability of an assessment contract from a program administrator, except under certain conditions. This control helps to ensure that good business practices are being followed and minimizes the opportunity for fraud.
- **No Contractor/Customer Kickbacks** – A program administrator cannot provide direct or indirect cash payments or anything of material value to a contractor or third party that is more than the actual price charged to the property owner. Likewise, a program administrator cannot provide direct or indirect cash payments or anything of material value to a property owner to obtain an assessment contract. These restrictions will help reduce incidences of fraud.
- **No Price Differentials** – A contractor cannot provide a different price for a project financed by a PACE assessment versus if the upgrade was paid in cash by the property owner. Again, this measure helps to reduce fraud.
- **Protection of Consumer Information** – A program administrator cannot provide information to contractors that discloses specific information that relates to the property owner or the property (for example, how much the property owner may qualify for). The protection of such information promotes good business practices and minimizes the potential for contractors to inflate home improvement measures based solely on financial ability rather than based on actual property needs.

- **Limits Tax Advice** – A program administrator, contractor, or other third party cannot make any representation as to the tax deductibility of an assessment contract, unless consistent with state and federal law. While this is a good business practice, we view this as credit neutral because there are exceptions. Property owners may want to seek independent tax advice.
- **Commencement of Work Guidelines/Property Restoration** – It is unlawful for the contractor to begin work under a home improvement contract if the property owner entered into the contract believing that the work would be covered by the PACE program and the property owner cancels the PACE financing within three days. In addition, a contractor who violates the guideline above must also restore the property to its original condition and return any money, property, or other consideration back to the property owner. These measures help to protect the consumer and promote good business practices for the contractor, but we view them as credit neutral because assessment quality may vary.

Other Legislative Proposals in California

PACE continues to be on the mind of the California legislature as three bills were introduced in February of this year. Each bill seeks to revise the existing PACE laws by providing additional clarity, promoting data transparency, and in some cases seem to overlap. If signed into law, these bills will further increase consumer protections, allow more latitude in oversight, and have a positive effect on the industry. [AB 2063](#), which was introduced into the California State Assembly on Feb. 7, proposes lengthening the document retention of information related to the PACE assessments to five years after the assessment is extinguished from three years and requiring the commissioner of the Department of Business Oversight to include the program administrator reports on PACE assessment contracts in the annual composite reporting.

Similarly, [AB 2150](#) was introduced on Feb. 12 and also seeks to have the commissioner include program administrator reports on PACE assessment contracts as part of the annual composite reporting. On this same day, [SB 1087](#) was also introduced into the California State Senate. In addition to other revisions, the bill proposes requiring program administrators to maintain their processes and practices in writing, requiring that the appraisal for a property's market value be independent, and allowing the commissioner to bring an order against a party without first having to file a report about the respective violation.

Positive Developments for Credit

Morningstar believes that regulatory oversight, improved underwriting, and disclosure guidelines aimed at better evaluating a property owner's ability to pay will help to increase consumer protections and promote good business practices across the broader industry, with generally positive effects on credit. We believe these measures will have greater reach beyond California. Program administrators will most likely adopt similar practices across the country and look to how the state addresses future legislation as a blueprint.

Appendix – Morningstar’s Credit View on AB 1284 and SB 242

[AB 1284](#)

Regulatory Oversight by the Department of Business Oversight	Credit Positive – Regulatory oversight will incentivize stronger business practices.
Improved Underwriting Guidelines	Credit Positive – An evaluation of a property owner’s ability to pay should result in better assessment quality.
Contract Criteria	Credit Positive – Various checks promote higher-quality underwriting.
Background Checks for Licenses	Credit Positive – A higher level of scrutiny and minimum financial requirements will help improve the quality of a PACE provider.
PACE Registry	Credit Positive – This will increase transparency and allow collection of data for performance metrics.
Minimum Training Requirements	Credit Positive – A higher level of expertise helps avoid misrepresentation.

[SB 242](#)

Semiannual Reporting	Credit Positive – This will increase transparency and allow collection of data for performance metrics.
Phone Calls	Credit Positive – This helps to ensure an understanding of PACE terms and promotes higher assessment quality.
Property Owner Disclosure	Credit Positive – Determining whether existing PACE assessments are outstanding improves cash flow analysis.
No First Payment Deferrals	Credit Positive – This promotes timely assessment payments.
Suitability/Right to Cancel	Credit Positive – This helps to ensure full understanding of PACE terms and promotes higher assessment quality.
Limited Conflicts of Interest Advertising/ No Kickbacks/ Price Differentials	Credit Positive – These are good practices and minimize the opportunities for fraud.
Protection of Consumer Information	Credit Positive – This promotes good business practices and minimizes the potential for contractors to inflate home improvement measures based solely on financial ability rather than based on property needs.
Limits on Tax Advice	Credit Neutral – While this is a good business practice, there are exceptions. Property owners may want to seek advice from their own tax attorneys.
Commencement of Work Guidelines/Property Restoration	Credit Neutral – This is beneficial to the consumer but does not necessarily affect assessment quality.

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