

America's Fastest-Growing Loan Category Has Eerie Echoes of Subprime Crisis

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Cindi Ventura helps her mother out of the San Jose, Calif., house where they live. They got a PACE loan for \$16,732 after eroded sewer pipes caused a flood. Photo: Preston Gannaway for The Wall Street Journal

By

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Deanna White told a contractor she couldn't afford the \$42,200 loan he recommended for improvements to her house in Inglewood, Calif. The contractor, she recalled, said she wouldn't be on the hook because the loan was part of a "government program." She applied and was approved.

Two years later, Ms. White is struggling to make payments on the loan, which was packaged with more than 10,000 similar loans into bonds and sold to investors. Under its terms, Ms. White's five-bedroom house could be foreclosed on if she defaults.

Her loan is part of a booming corner of the lending industry called Property Assessed Clean Energy, or PACE. Such loans, set up by local governments across the U.S., are designed to encourage homeowners to buy energy-efficient solar panels, window insulation and air-conditioning units.

About \$3.4 billion has been lent so far for residential projects, and industry executives predict the total will double within the next year. That would likely rank PACE loans as the fastest-growing type of financing in the U.S.

As the loans spread, so do problems that echo the subprime mortgage crisis. Plumbers and repairmen essentially function as loan brokers but have scant training and oversight. They often pitch PACE loans to help land contracting jobs and earn referral fees from lenders, according to loan documents and more than two dozen borrowers, industry executives and employees.

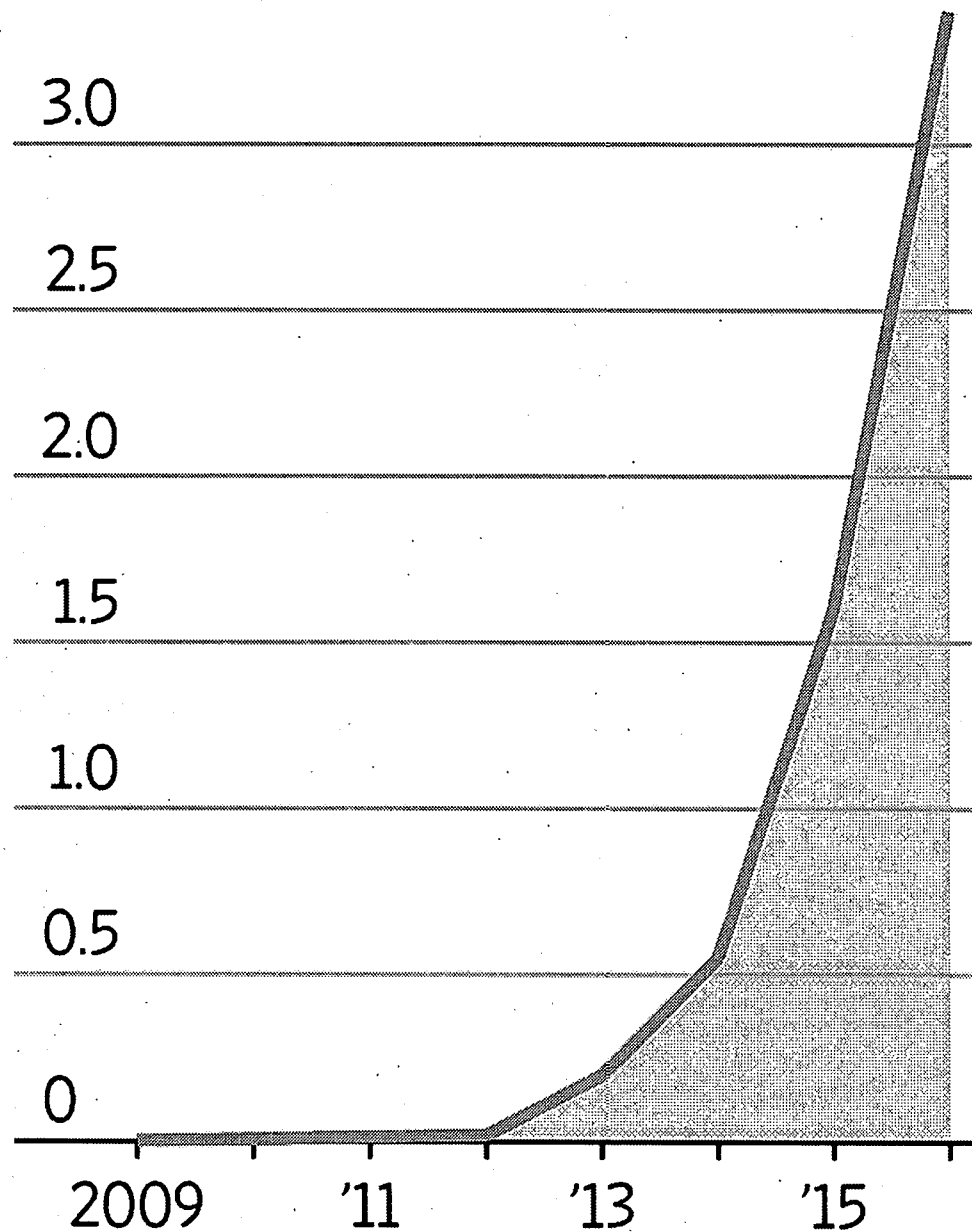
04/12/2018

Home Improvement

Cumulative PACE financing for residential projects

\$3.5 billion

2016: \$3.4 billion*



04/12/2018

*Through Dec. 20

Source: PACENation

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Creditworthiness matters little to lenders, because loans are based on the value of a homeowner's property. PACE loans typically require no down payment, and the debt is added to property-tax bills as an assessment. Ms. White's annual property taxes soared to \$6,500 from \$1,215.

Loan growth is fueled partly by investor appetite for bonds created from PACE loans, especially among mutual funds and insurers. Investors like the bonds' relatively high payouts, environmentally friendly reputation and lofty credit ratings. On the other hand, rating firms have said there aren't enough historical data on PACE loans to forecast potential defaults.

Some local governments that embraced the loans as a way to bring clean energy to the masses didn't anticipate the messy consequences.

"We wanted to put ourselves in the thick of this," says Rick Bishop, executive director of the Western Riverside Council of Governments, a group of city and county governments in California that helps run the largest PACE program. "The downside is now we hear about these stories from people who feel like they've been misinformed in some fashion."

The government group tries to resolve problems for borrowers. Riverside County, Calif., has opened an investigation into marketing practices for PACE loans, and California Gov. Jerry Brown signed into law in September new requirements establishing uniform disclosures for PACE loans, an effort to make lending terms closer to those for mortgages. Homeowners who get a PACE loan now have three days to back out.

The largest PACE lender, Renovate America Inc., is accused in three lawsuits filed in November by borrowers of double-charging interest and administrative fees and failing to immediately credit loan payments. The suits seek class-action status. The company denies the allegations and says it will "defend PACE, our company and the program vigorously."

In November, the Energy Department urged administrators of the loan programs to clearly explain loan costs and other terms, allow borrowers to cancel their loan during a short period and deter kickbacks to contractors.

Industry executives say most borrowers are satisfied with their loans and defaults are rare.

Lenders are working with consumer groups to create nationwide standards "to prevent things that wouldn't benefit consumers," says JP McNeill, Renovate America's founder and chief executive.

The growing pains are largely the result of the industry's young age, the executives say. The first PACE program was started in 2007 by Cisco DeVries, then chief of staff to the mayor of Berkeley, Calif.



Cisco DeVries, center, at the Cities for Tomorrow conference in New York in July 2015, calls himself a 'capitalist hippie' and is chief executive of clean-energy company Renew Financial Group. Photo: Larry Busacca/Getty Images

Thirty-four states and Washington, D.C., have passed legislation allowing the creation of PACE programs, according to PACENation, an industry trade group in Pleasantville, N.Y.

Mr. DeVries, who calls himself a "capitalist hippie" and now is chief executive of Renew Financial Group LLC, a clean-energy finance company in Oakland, Calif., says he is "really proud of what we've accomplished." He adds: "We set out to help people save money and save energy, and it's under way."

The industry could get a new growth spurt from a July decision by the Department of Housing and Urban Development to allow the Federal Housing Administration to purchase mortgages on homes with PACE loans.

PACE loans range in size from about \$5,000 to more than \$100,000, with an average of about \$25,000, and charge interest rates of 6% to 9% over a repayment period of usually five to 25 years.

Instead of making monthly mortgage payments, PACE borrowers pay what they owe once or twice a year along with their property taxes. Cities and counties collect the loan payments and pass along the money to lenders.

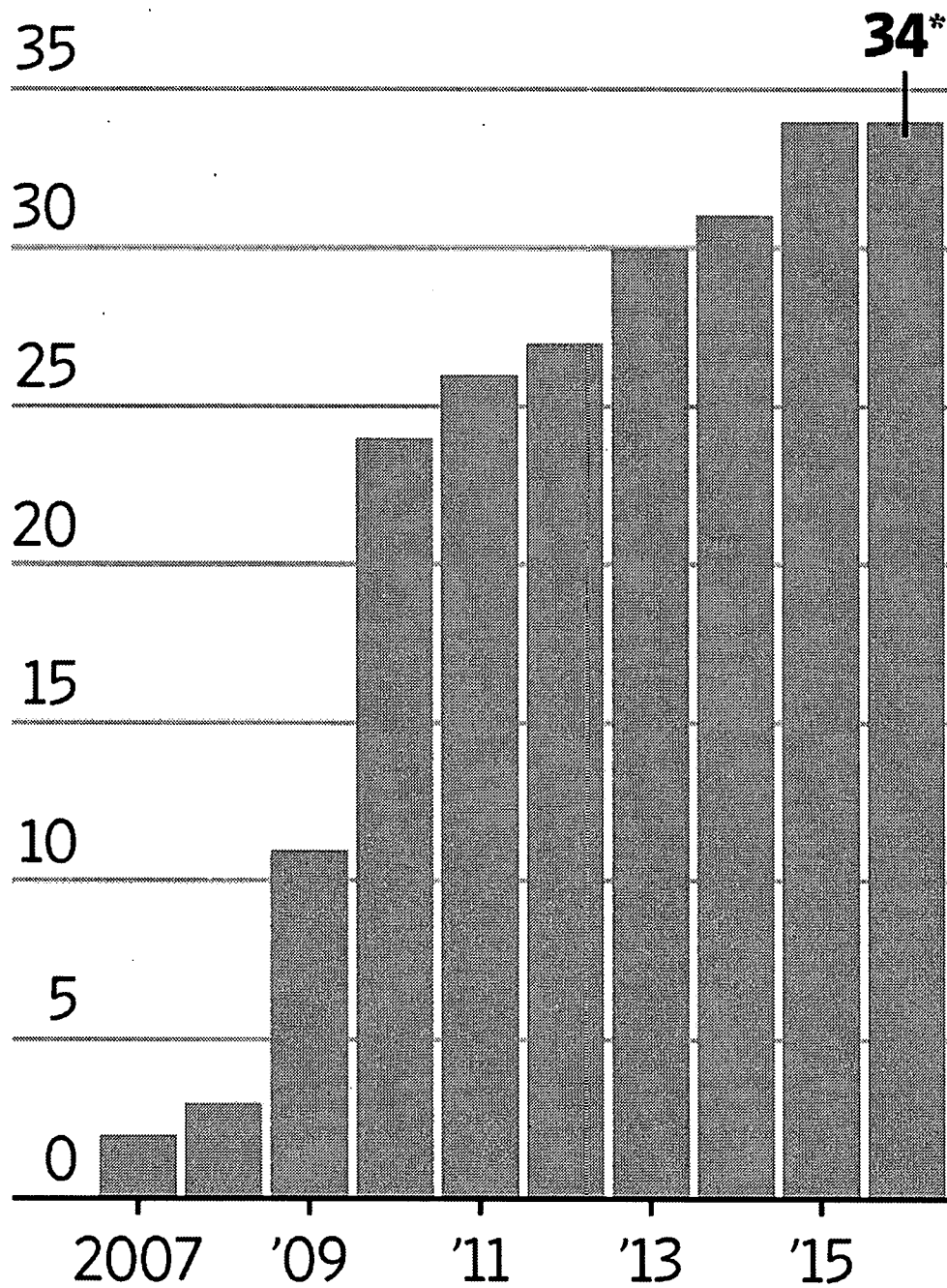
Local governments collect fees from finance companies. In the fiscal year that ended June 30, the Western Riverside Council of Governments collected revenue of \$7.1 million, or about 15% of its budget, from the PACE program.

Another quirk of PACE loans is that the debt usually goes to the front of the line, ahead of the homeowner's mortgage. Like a typical tax assessment, that means if a homeowner defaults on the PACE loan, the property can be seized as collateral and sold to repay the lender.

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Across the U.S.

Number of states with PACE legislation



*As of Dec. 20

Source: PACENation

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That setup puts local governments in the awkward position of potentially foreclosing on their constituents. If that happens and the house turns out to be worth less than the amount owed by the homeowner, other taxpayers could be stuck with a loss on the difference. So far, that hasn't happened.

Some investors say the extensive involvement in PACE loans by governments across the country amounts to an implicit financial backstop. The belief that governments stand behind the loans is a major reason why investors are attracted to the bond deals, according to investors.

"There is such big national and state backing," says Mike Warmuth, portfolio management vice president at FBL Financial Group Inc., the owner of Farm Bureau Life Insurance Co. in West Des Moines, Iowa. The insurer owned \$22 million of PACE bonds at the end of September.

Mr. Warmuth says the insurer's broker suggested the bonds, which generally yield about 4%. He says he isn't aware of any underwriting deficiencies with the loans, adding that Farm Bureau only had access to aggregate loan data before buying the bonds.

Defaults on loans in PACE bond deals overall have been less than 1%, according to Kroll Bond Rating Agency Inc. Cecil Smart, a senior director at the ratings firm, says the bond deals are structured so that lenders bear the brunt of any losses, rather than investors.

Germany's Deutsche Bank AG is one of the largest packagers of PACE loans into securities and led a \$284 million deal in mid-December, which drew far more investor demand than expected. The bank is aware of problems stemming from the role of contractors, says a person familiar with the matter.

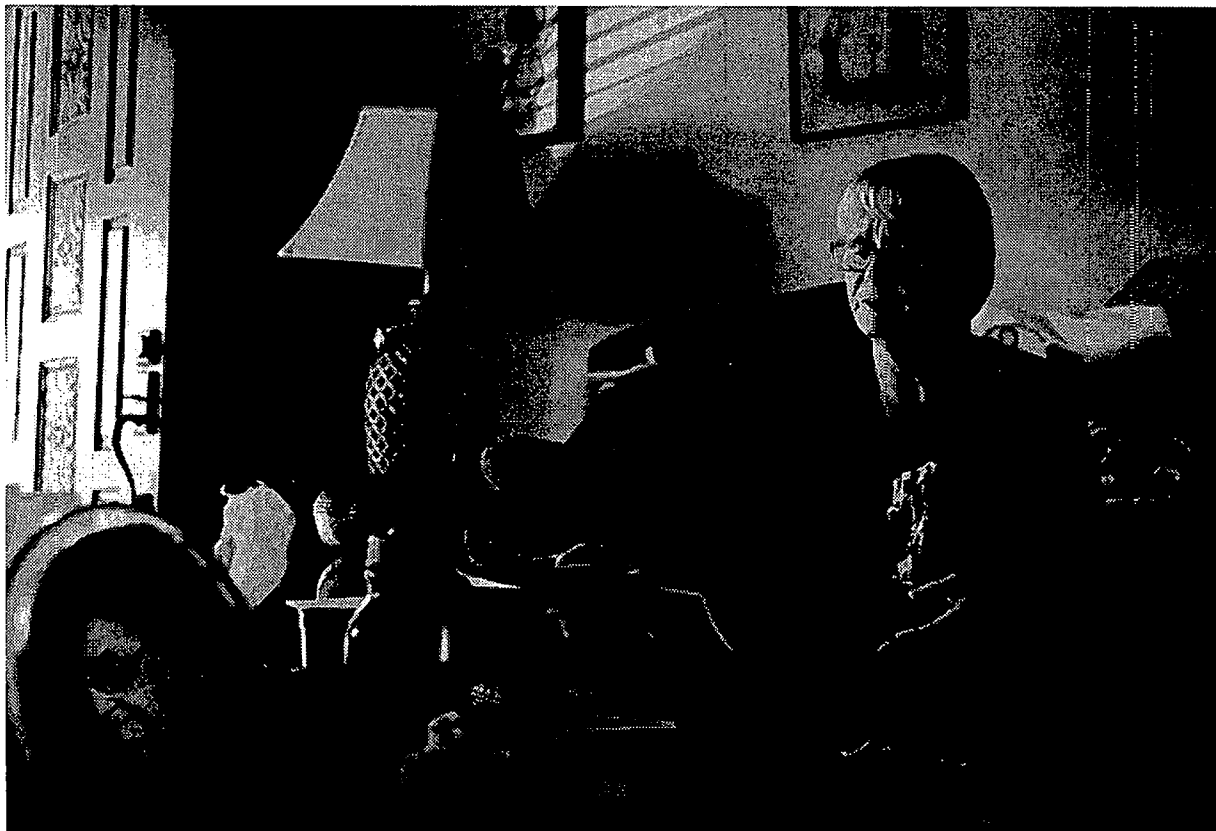
Contractors often line up loans while on house calls and can earn a referral fee of at least \$500 per borrower, according to current and former employees. The loans also are marketed at county fairs and by cold calling, borrowers say.

Renovate America uses about 8,000 contractors to help line up loans, according to bond documents. Those contractors are overseen by 23 employees at the San Diego company.

The company says it recently put in place a more-stringent contractor management program. Renovate America says only about 200 contractors are actively arranging PACE loans.

Cindi Ventura, 65 years old, says she was urged last summer by her plumber to apply for a PACE loan after sewer pipes eroded underneath her three-bedroom house in San Jose, flooding the property. She said she had recently filed for personal bankruptcy, didn't have the money to make all the repairs and couldn't qualify for a home-equity line of credit.

She and her mother, 83, received a \$16,732 loan for five years from Ygrene Energy Fund Inc. with a 6.5% interest rate. Ygrene ("energy" spelled backward), based in Santa Rosa, Calif., is the second-largest provider of PACE financing in the country, based on loan volume.



Cindi Ventura helps her mother sort old family photographs. She says she was confused about terms of their PACE loan because it was called an assessment. Photo: Preston Gannaway for The Wall Street Journal

Ms. Ventura, a receptionist, says she was confused about the loan's terms because it was called an assessment. She says she called and emailed Ygrene several times with questions about her loan documents and never heard back. "I still don't really understand what the program is," she says.

Louis Lalonde, chief marketing officer of Ygrene, says company representatives had a call with Ms. Ventura and her mother to answer all their questions before the loan was signed. He says he has no record of any further attempts to contact them.

The 3,200 contractors who drum up business for Ygrene are regularly screened for compliance with contractor licensing requirements and receive training before they are allowed to pitch loans to homeowners, he adds.

Malcolm Scott, 61, was planning to pay in cash the \$34,000 it would cost for a new air-conditioning unit, furnace and other improvements at his house in Woodland Hills, Calif. His contractor suggested applying for a PACE loan.

Mr. Scott was surprised to find out less than 24 hours later that he had been approved for \$94,000. Renovate America says he qualified for the larger loan based on the amount of equity in his house. He decided to borrow just the \$34,000.

Michael Gardner, who runs Mediterranean Heating & Air Conditioning, which lined up the loan, says he has been recommending loans for about two years and got "an hour or two" of online training from Renovate America.

The program "is real nice because there are no FICO score requirements or anything like that," says Mr. Gardner.

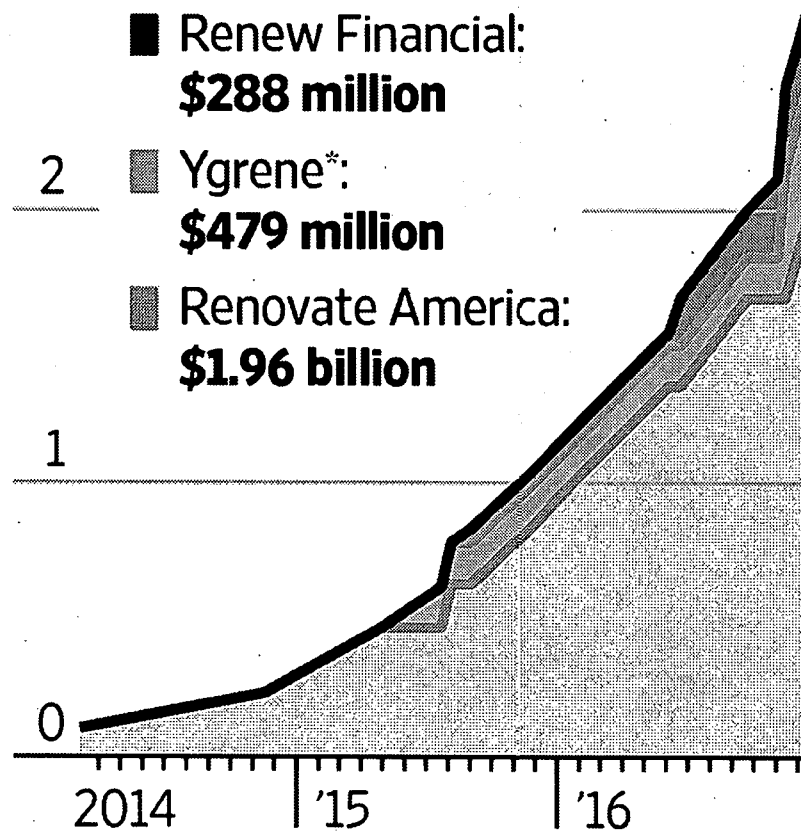
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Hungry Investors

The growth of PACE loans has been fueled partly by investor appetite for bonds created from the loans.

Cumulative securitization of residential PACE loans* by dollars funded

\$3 billion



Note: Through Dec. 15

*Ygrene includes some commercial loans.

Source: PACENation

04/12/2018

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Some lenders have taken steps to strengthen underwriting practices, make loan documents more transparent and boost contractor oversight. Renovate America now requires in-house representatives to speak with a borrower by phone—outside of the room and away from the contractor—before signing a homeowner up for a PACE loan.

Renovate America, which is backed by nine private-equity and venture-capital firms, says it has spent the last several months working with consumer groups and regulators to come up with national lending standards for PACE. The new standards could include a year with no payments for borrowers who are suffering from an economic hardship.

"At the end of the day, PACE is an unregulated industry, and it's just a matter of time before we get regulated," says Mr. Lalonde of Ygrene.

Phil Adleson, a lawyer in San Jose, Calif., who represents borrowers, says PACE is "a very great idea implemented in a dangerous fashion."

Ms. White, the borrower in Inglewood, a neighborhood in Los Angeles County, says a contractor from a company named the House Next Door told her in late 2014 not to worry that she couldn't afford the \$42,200 loan because "it wouldn't be coming out of my pocket."

The company says no one there would ever describe PACE loans like that and says Renovate America has held weekly training sessions for its contractors for "more than a year."

Ms. White says the contractor finished the drought-resistant landscaping at her house only after being contacted by a Journal reporter. Renovate America says the contractor has been "under suspension" for the past several weeks.

Her loan went into a pool of 11,282 PACE loans that are collateral on bonds issued by the Western Riverside Council of Governments. Deutsche Bank packaged the bonds into a \$240 million deal called "HERO Funding Trust 2015-1." Kroll gave it a AA rating, the firm's third-highest.

According to the latest available figures, fewer than 70 of the underlying PACE loans have defaulted, and Kroll said the transaction "has performed as projected."

Ms. White's next loan payment is due in April. She says she doesn't know how she will be able to pay it.

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