

Date of Hearing: July 15, 2015

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT
Brian Maienschein, Chair
SB 602 (Monning) – As Amended June 17, 2015

SENATE VOTE: 38-0

SUBJECT: Seismic safety: California Earthquake Authority.

SUMMARY: Authorizes the California Earthquake Authority to enter into voluntary contractual assessments with property owners to finance the instillation of seismic strengthening improvements. Specifically, **this bill:**

- 1) Extends the authority granted to public agencies, cities, and counties, to the California Earthquake Authority (CEA) to enter into voluntary contractual assessments with property owners to finance the installation of seismic strengthening improvements that are permanently fixed to real property.
- 2) Makes changes to the definition of "public agency" to include CEA and adds "governing body" to the authorization under existing law related to contractual assessments granted to a legislative body.
- 3) Authorizes the CEA, unless otherwise specified in a resolution of intention and a report pursuant to existing law, to enter into voluntary contractual assessments with property owners to finance the installation of seismic strengthening improvements that are permanently fixed to real property throughout the entire state.
- 4) Provides that the CEA is not required to designate, describe, or provide a map of that area in the resolution of intention or the report required under existing law, unless that area covers an area smaller than the entire state.
- 5) Requires the CEA to publish notice of the hearing to create the voluntary contractual assessment program to finance the installation of seismic strengthening improvements solely in a newspaper of general circulation within Sacramento County.
- 6) Provides that existing law that requires notification to water and electric providers does not apply to a voluntary contractual assessment program, which solely finances the installation of seismic strengthening improvements that are permanently fixed to real property.
- 7) Requires that any voluntary contractual assessments entered into with respect to a program established by CEA, be made under the payment schedule set forth in the contract providing for that voluntary contractual assessment, whether or not any bonds secured by that voluntary contractual assessment have been issued.
- 8) Adds the CEA to the definition of 'city' in the Improvement Bond Act of 1915.

EXISTING LAW:

- 1) Authorizes a public agency to enter into a contractual assessment with a willing property owner to finance the installation of seismic strengthening improvements.

- 2) Requires the governing body to adopt a resolution to use voluntary contractual assessments, which would do the following:
 - a) Determine that it would be convenient, advantageous, and in the public interest to designate an area within which officials and property owners may enter into contractual assessments and make related financing arrangements;
 - b) Identify the kinds of public works, distributed generation renewable energy sources, or energy or water efficiency improvements which may be financed;
 - c) Describe the area where contractual assessments may be used;
 - d) Describe the proposed financing arrangements, including criteria for determining the creditworthiness of a property owner;
 - e) State the time and place for a public hearing; and,
 - f) Direct an official to prepare a detailed report about the contractual assessment program and consult with the county auditor and county controller regarding fees.
- 3) Requires the report to contain the following:
 - a) A map of the area where contractual assessments will be offered;
 - b) A draft contract specifying the terms and conditions that would be agreed to by a property owner and the public agency;
 - c) A statement of public agency policies concerning voluntary contractual assessments, including all of the following:
 - i) A list of the types of facilities and improvements which may be financed;
 - ii) The official authorized to enter into contractual assessments on behalf of the county or city;
 - iii) The maximum aggregate dollar amount of contractual assessments; and,
 - iv) A method for prioritizing requests from property owners for financing;
 - d) Information about the county auditor's and county controller's fees.
- 4) Authorizes a public agency to issue bonds and to repay the principal and interest with the voluntary contractual assessment.
- 5) Authorizes a public agency to advance its own funds to finance work to be repaid through voluntary contractual assessment, and from time to time, sell bonds to reimburse itself.

- 6) Allows a public agency to enter into a relationship with an underwriter or financial institution that would allow the sequential issuance of a series of bonds, issuing each bond as the need arises to finance work to be repaid through the voluntary contractual assessments.
- 7) Provides that assessments and the interest and penalties shall constitute a lien against the lots and parcels of land on which they are made, until they are paid.

FISCAL EFFECT: According to the Senate Appropriations Committee, minor, absorbable one-time costs to the Department of Insurance (Special Fund). The Department of Insurance indicates one-time costs of less than \$5,000 to review and evaluate the proposed financing programs. All costs for the retrofitting program are paid from non-state sources through the CEA.

COMMENTS:

- 1) **Voluntary Contractual Assessments.** AB 811 (Levine), Chapter 159, Statutes of 2008, proposed to further the public interest of addressing climate change through energy conservation efforts by authorizing public agencies (cities and counties) to provide up-front financing to property owners to install renewable energy sources or energy efficiency improvements that are permanently fixed to their properties through a system of contractual assessments.

Many local governments utilize the authorization granted by AB 811 to do PACE (Property Assessed Clean Energy), a financing tool that residential or commercial property owners can use to pay for renewable energy upgrades, energy or water efficiency retrofits, or electric vehicle charging stations for their homes or buildings. Local agencies create PACE assessment districts in their jurisdictions via a resolution of their legislative body, allowing the local agency to issue bonds to finance the up-front costs of improvements. In turn, property owners enter into a voluntary contractual assessment agreement with the local agency to re-pay the bonds via an assessment, secured by a priority lien, on their property tax bill. The intent of the program is that the assessment remains with the property even if it is sold or transferred, and the improvements must be permanently fixed to the property.

In California, instead of local governments administering their own PACE programs, the majority of local governments partner with a third-party to carry out their PACE programs. The cost of third-party administration is not borne by the local agency, but is built into PACE loan financing. Some of these programs focus on residential projects, others target commercial projects, and some handle both residential and commercial portfolios. Joint powers authorities (JPAs) also administer PACE programs and/or are involved in issuing bonds for third-party administrators.

The use of voluntary contractual assessments has been expanded by the Legislature several times. AB 474 (Blumenfeld), Chapter 444, Statutes of 2009, added water efficiency improvements, SB 1340 (Kehoe), Chapter 649, Statutes of 2010 added electric vehicle charging infrastructure, and most recently, AB 184 (Swanson), Chapter 28, Statutes of 2011, added seismic strengthening improvements that are permanently fixed to real property to the list of improvements that can be paid for through a contractual assessment between a willing property owner and a public agency.

Only a few local governments have begun to use voluntary contractual assessments for seismic improvements. For example, the City of Berkeley and the City and County of San Francisco began to offer financing for improvements to soft, weak and open front (SWOF) buildings and additional voluntary seismic retrofits by a voluntary contractual assessment program administered by Alliance NRG.

- 2) **Bill Summary.** This bill extends the authority currently granted to cities and counties to establish voluntary contractual assessment programs for seismic improvements to the CEA. Under this bill, the CEA can create a statewide program, in which they are not subject to mapping and other reporting requirements applied to local governments under current law. This bill also exempts the CEA from specified reporting requirements for local governments, and instead, requires the CEA to publish notification of a hearing to establish a contractual assessment program in a newspaper of general circulation within Sacramento County.

Additionally, this bill would expand the authorized uses of funds in the Earthquake Loss Mitigation Fund within CEA to include the seismic strengthening improvements authorized in the statutes governing voluntary contractual assessments.

This bill also exempts voluntary contractual assessment programs for seismic improvements from complying with notification requirements to water and electric providers.

This bill is author-sponsored.

- 3) **Author's Statement.** According to the author, "Currently, fewer than 11% of California homeowners purchase earthquake insurance, despite predictions that the state will experience a major earthquake sometime in the next 30 years. Homeowners can, however, greatly reduce their exposure to earthquake damage by taking relatively simple, low cost steps to strengthen their structures to better withstand earthquakes.

"Existing law establishes the Earthquake Loss Mitigation Fund (ELMF) within the California Earthquake Authority to provide grants or loans to dwelling owners who wish to retrofit their homes. The ELMF is allocated five percent of CEA's investment income, or \$5 million, whichever is less, annually. The fund currently has about \$24 million available for mitigation loan financing.

"This bill will allow the CEA to create a new voluntary financing tool for homeowners to mitigate and retrofit their homes. The Property Secured Mitigation Program (PSMP) would allow the CEA to provide 100% financing for residential mitigation projects that meet approved engineering guidelines. The loan would become a lien on the property and allow homeowners to pay for the costs in installments in the form of debt service payments collected through existing property tax collection mechanisms. The lien would "run with the land," staying with the property upon sale. Such seismic retrofitting would reduce the likelihood of serious damage in the event of a major earthquake, and make the property eligible for earthquake insurance premium discounts."

- 4) **CEA.** The CEA was formed by the Legislature in 1995/96 to address an insurance-availability crisis that followed the 1994 Northridge earthquake. After that earthquake, many homeowners found it difficult or impossible to find basic homeowner's insurance. The CEA is a publicly managed, privately funded entity with a governing board that provides oversight of their operations. The governing board has three voting members, the Governor, State

Treasurer, and Insurance Commissioner, and two non-voting members: the Speaker of the Assembly and the Chair of the Senate Rules Committee. According to CEA, they are the largest earthquake insurer in California, with over 75% of the residential-earthquake-insurance market. Additionally, CEA participating insurers are responsible for almost 80% of California's residential property insurance. The CEA also offers seismic retrofit incentives to homeowners through the ELMF in the form of grants, loans, and loan guarantees for homeowners to protect their homes against earthquake damage.

In August 2011, the California Residential Mitigation Program (CRMP) was established as a joint-exercise-of-powers entity by the CEA and the Governor's Office of Emergency Services (Cal OES), to carry out mitigation programs to assist California homeowners to seismically retrofit their houses. CRMP's goal is to provide grants and other types of assistance and incentives for these mitigation efforts. The CRMP's first program, launched in 2013, is the "Earthquake Brace and Bolt" (EBB) program, providing grants of up to \$3,000 for homeowners who have qualifying homes and meet specified building code requirements. In the Budget, the EBB Program received a \$3 billion allocation for the 2015-16 Fiscal Year to expand the program. According to the CEA, 16 homes have qualified and completed retrofits under the program, and 650 retrofits are planned in 2015. CEA estimates that there are approximately 1.6 million owner-occupied houses in California that have meet the criteria of the EBB – 1.2 million of those are in higher-hazard areas.

The cost of EBB retrofits is between \$3,000 and \$6,000 for the single-family dwellings presently eligible. However, more complicated retrofits (e.g., for "soft-story" and hillside houses), are more expensive. Proponents of this bill argue that this bill could be used for projects similar to the EBB, as well as for retrofitting houses with soft first-stories (e.g., living space over the garage), which can cost \$10,000 to \$20,000. The CEA ELMF has \$25 million available today and is projected to accommodate about 6,000 homes in the next six years.

- 5) **Federal Housing Finance Agency Concerns with Residential PACE.** The authority granted by this bill is specific to seismic improvements, not energy efficiencies, however, absent any direction from Federal Housing Finance Agency (FHFA) on their position to distinguish PACE from the authority granted by this bill, concerns expressed over residential PACE may extend to the voluntary contractual assessment program established by CEA.

In 2010, FHFA, which oversees the nation's largest mortgage finance companies, Fannie Mae and Freddie Mac, raised concerns that residential PACE financing could pose a risk for federal mortgage enterprises (Fannie Mae and Freddie Mac), because PACE loans are a first-priority lien in the case of foreclosure and lenders would have to pay outstanding PACE assessments before paying mortgage costs. In August of 2010, Fannie Mae and Freddie Mac announced they would not purchase mortgages for homes with first lien priority PACE obligations. The FHFA's action triggered many local governments to suspend their residential PACE programs.

To address this concern, the Legislature enacted SB 96 (Committee on Budget and Fiscal Review), Chapter 356, Statutes of 2013. This budget trailer bill tasks the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) with administering a PACE loss reserve program of \$10 million to keep mortgage interests whole

during a foreclosure or a forced sale. CAEATFA recently filed its regulations for the program, and is now accepting applications from PACE administrators.

The PACE Loss Reserve Program will compensate first mortgage lenders for losses resulting from the existence of a PACE lien in a foreclosure or forced sale. The program will cover PACE payments made during foreclosure, if a mortgage lender forecloses on a home that has a PACE lien, and any losses to a first mortgage lender up to the amount of outstanding PACE payment, if a county conducts a forced sale on a home for unpaid taxes. The intent of the Program is to put the first mortgage lender in the same position it would be in without a PACE lien.

The FHFA issued clarity to their position following the creation of the PACE Loss Reserve Program, in a letter to the Governor dated May 1, 2014, which reads, "I am writing to inform you that FHFA is not prepared to change its position on California's first-lien PACE program and will continue to prohibit the Enterprises from purchasing or refinancing mortgages that are encumbered with first-lien PACE loans...In making this determination, FHFA has carefully reviewed the Reserve Fund created by the State of California and, while I appreciate that it is intended to mitigate these increased losses, it fails to offer full loss protection to the Enterprises. The Reserve Fund is not an adequate substitute for Enterprise mortgages maintaining a first lien position and FHFA also has concerns about the Reserve Fund's ongoing sustainability. "

6) **Policy Considerations:** The Committee may wish to consider the following:

a) **Intent of Voluntary Contractual Assessments.** The Committee may wish to consider if the authorization granted by this bill continues to push the statutes governing voluntary contractual assessments further away from their original intent. Very few local governments have taken advantage of the authorization to do seismic improvements and the majority of local governments do not administer their own PACE programs, but rather contract with a third-party.

The Committee may wish to consider, given outstanding and unresolved issues with FHFA and the evolution of other voluntary contractual assessment programs, if this is an appropriate time to further expand the authority to administer voluntary contractual assessments to entities beyond local governments.

b) **Priority Lien.** The California Association of Realtors in opposition, argues, "In light of the ongoing harsh policy rhetoric from the FHFA in regard to PACE assessments, we are concerned that encouraging the same super-lien priority of seismic funding will endanger the availability of mortgage financing for the property. It would be a cruel irony for a homeowner to strengthen the home to protect his or her equity from earthquake, only to find that the very mechanism to protect it makes the home unmarketable." Further, opposition, in a joint letter, states "The consequences are substantial and may preclude a borrower from completing a necessary transaction. Ultimately, a borrower needing to refinance or sell their property will be forced to pay the entirety of the balance of the seismic strengthening improvements. Depending on the amount financed for the seismic strengthening improvement loan and the borrower's financial condition, they may not have the ability to achieve payoff."

- c) **Notification to Homeowners.** One of the concerns previously expressed in an FHFA statement included a concern that PACE loans lack adequate consumer protections, including those provided under the federal Truth-in-Lending Act. The Press Enterprise reported in June that the Riverside County District Attorney's office is investigating the HERO program and the way consumers are being sold energy efficient products, which includes an examination of current disclosure practices.

In light of these concerns relative to existing residential PACE programs and the potentially statewide nature of the CEA program authorized by this bill, the Committee may wish to ask the author to accept amendments that would require additional notification to homeowners prior to entering into voluntary contractual assessments for seismic improvements, which identify not only the terms and conditions, but also the impact of the assessments on existing mortgages and the property owner's ability to sell or refinance their home.

- d) **Requirements for Public Agencies.** Current law establishes a number of requirements for a local agency upon passage of a resolution to authorize voluntary contractual assessments. One of these requirements is a report which must include specified information regarding the contractual assessment program. For example, the report must include a brief description of criteria for determining the underwriting requirements and safeguards that will be used to ensure that the total annual property tax and assessments on the property will not exceed 5% of the property's market value, and a plan for raising a capital amount required to pay for work performed pursuant to contractual assessments. This bill explicitly exempts CEA from a number of requirements, based on the statewide nature of the proposed program. The bill does not explicitly require CEA to comply with a number of other requirements, as mentioned above.

The Committee may wish to ask the author to accept an amendment to make it clear that a legislative body and a governing body (CEA) must comply with the requirements to establish a voluntary contractual assessment program for seismic strengthening improvements under existing law.

- e) **Stop-Gap.** The PACE Loss Reserve Program does not apply to seismic improvements, therefore, the Committee may wish to ask the author to accept an amendment for the CEA to create its own internal loss reserve program at an amount relative to its program.
- f) **Qualified Property Owners.** Due to its enabling legislation, the CEA would only be able use the authority granted by this bill for residential seismic improvements. The Committee may wish to ask the author to narrow the scope of the authority granted by this bill to homes that require seismic improvements in order to comply with building code requirements.
- 7) **Arguments in Support.** Supporters argue that this bill is imperative to ensure that California infrastructure is prepared for the next big earthquake that will inevitably occur within the state. This bill will provide funding to allow retrofitting of California infrastructure to defend against an earthquake. The R Street Institute argues, "Concerns about the impact of PACE-like programs have been expressed by federal lending authorities in the past. Their concerns, centered on the seniority of PACE liens, have proven to be illusory...To date, 31 states have enabled PACE programs and California's approach has

been a terrific success. Applying a similar principle to seismic retrofitting would be both a national first and a step toward addressing California's urgent vulnerability to earthquakes."

- 8) **Arguments in Opposition.** Opposition argues that while this bill relates to seismic strengthening improvements and not clean energy, the methodology for funding the seismic strengthening improvements is identical and contained within the same body of law. Specifically, opposition points to the following concerns: 1) PACE lending dries up liquidity for making loans; 2) PACE lending hurts consumers; 3) PACE lending methods increase the risk of loss to taxpayers; and, 4) a lack of underwriting standards. Therefore, because of the concerns and issues surrounding the FHFA and treatment of PACE liens, opposition argues that an expansion of tax lien-based funding mechanisms are anti-consumer for unwary homeowners and potentially have a negative impact on California's real estate economy.
- 9) **Double Referral.** This bill was heard by the Insurance Committee on June 24, 2015, where it passed with a 13-0 vote.

REGISTERED SUPPORT / OPPOSITION:

Support

American Red Cross
Association of Bay Area Governments (ABAG)
Automobile Club of Southern California
California Department of Insurance
R Street Institute

Opposition

California Association of Realtors
California Bankers Association
California Credit Union League
California Independent Bankers
California Land Title Association
California Mortgage Association
California Mortgage Bankers Association

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