State of Oregon Department of Environmental Quality

Previously proposed CDFI Lending Framework (October 2020)

Clean Water State Revolving Fund 2020 Rulemaking

Advisory Committee Meeting #4

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Market rate – Prime rate (3.25%)
DEQ's rationale: The prime rate that DEQ proposes is the most appropriate rate for this type of lending. 1. DEQ sought a fixed rate index as a base rate index to define "market rate" because a variable rate would be less stable. 2. Prime rate is a fixed rate that varies with the economy, not daily or monthly. a. Wall Street Journal publishes the prime rate based on Federal Reserve's federal refund rates. b. Typical "best rate" banks offer for home mortgages and therefore is a reasonable metric for septic system assets, which is typically a home asset. c. It's commonly accepted and understood. It's easily accessible. DEQ reviewed commercial lending rates but doesn't recommend another rate because: • Commercial lending rates vary by industry type, type of bank, investor type, mission and geography. • Each bank's commercial lending ranges broadly five to 12 percent. • Not as stable or as affordable as the 30-year mortgage rate **Municipal bond rate:** Municipal bond rates are set for public agencies, therefore nonprofit CDFIs are not eligible for public agency rates because a CDFI cannot pledge its taxing power. **Interest rates offered to CDFIs:** CDFIs do borrow money with a range of interest rates, some are lower and some are higher than DEQ's proposals.

DEQ below-market rate (known as "DEQ rate") – 50 percent of prime rate (1.63%)
DEQ's rationale: The purpose of the CWSRF is to promote loan affordability by offering "below-market" interest rates. DEQ modeled the 50 percent of the base rate offering after the Local Community Loan's 50 percent of base rate offering. The Local Community Loan is DEQ's other pass-through loan offering.

- **Maximum loan amount –** $1M per CDFI, per year
- **Total CDFI lending limit per state fiscal year –** $5M (five CDFI loans per year)

DEQ's rationale:
DEQ, with input from the RAC and PFM, determined that a maximum lending limit per loan and aggregated CDFI lending cap should be set to mitigate potential loan loss associated with private lending. This limit allows for the minimum amount of potential loan losses without harming the fund's perpetuity.

The annual limit also allows DEQ to evaluate CDFI loan performance on an annual basis.

If DEQ increased the annual loan limit:
- The maximum principal forgiveness award would still be a maximum of $500,000 per project year because that is the maximum principal forgiveness award for any one loan, reducing the percentage of principal forgiveness for any one CDFI.
- There will be less funding available for other CDFIs that may want access to CWSRF loans.

CDFI rate (on sub-loans) – DEQ rate plus two percent (maximum)

DEQ's rationale:
The 2 percent markup on the DEQ rate ensures that the CDFI can generate some profit on the sub-loans and will ensure that loan affordability will be passed on to sub-borrowers.

It is not the purpose of the CWSRF to allow a borrower to set a commercial or variable interest rate on sub-loans using CWSRF loan proceeds.

DEQ understands the costs of running a loan program, and has worked to reduce the repayment amount so that the proceeds coming back to CDFIs will exceed their repayment to DEQ and revolve back into the program.

Project period (loan disbursement period) – One year from date of loan signature

DEQ's rationale:
- The Clean Water Act requires borrowers enter into repayment 12 months or one year after the project's construction phase is complete.
- Setting the project period to one year ensures that the projects funded by the sub-loans will not exceed the one year window.

DEQ annual fee – 0.5 percent on loan balance

DEQ's rationale:
This is DEQ's standard CWSRF annual loan fee to cover program administration.

Based on the proposed CDFI lending requirements, DEQ will earn $1,340/year on a CDFI loan once it goes into repayment. Though the fee will not cover DEQ's costs of lending to CDFIs, DEQ did not propose an increase in fee to keep the loan affordable for both CDFIs and their sub-borrowers.

Loan term – Maximum 20 years; must match the sub-loan terms

DEQ's rationale:
DEQ proposes to offer a maximum loan term of 20 years because the *average* useful life of a septic system is 20 years. DEQ expects the DEQ loan and the CDFI's sub-loans to have the same term length because the federal rules prohibit CWSRF programs from lending beyond an asset's useful life. Therefore no DEQ loan or CDFI sub-loan will exceed a 20-year term.

However, DEQ could offer a CDFI a shorter term (5, 10, 15 years) if the sub-loans also have a shorter term.

Principal forgiveness – 50 percent or $500,000, whichever is less

DEQ's rationale:
Principal forgiveness offered to the CDFI is intended to keep the sub-loan rates low. DEQ understands the administrative costs of running a loan program. The principal forgiveness will reduce the CDFI's repayments to DEQ so that the loan proceeds coming back to CDFIs from sub-borrowers will exceed the CDFI's repayment to DEQ, therefore making more funds available to the CDFI to revolve back into the CDFI's septic system lending program.

CDFI program income/profit – Restrict the asset to the CDFI's septic lending program exclusively; Cannot be used to fund other CDFI grant or loan programs

DEQ's rationale:
The restriction ensures that profit made on the CWSRF loan revolves back into the same lending program for the same purpose, which will encourage the CDFI's loan fund to revolve and ensure that money made available through CWSRF continues to serve the intended purpose.

Fully amortized CDFI loan and sub-loan – CDFI loans and sub-loans must be fully amortized with equal installment payments.

Fully amortized loans of equal installment payments is a best lending practice and ensures timely repayments within the useful life of the asset.

DEQ acknowledged that short-term hardship deferrals are part of lending. However, long-term deferments or balloon payments are not a sustainable financial practice because they can have a detrimental impact on the economic sufficiency of the sub-borrower and can lead to future environmental impacts if the asset were to fail again during a long-term deferment on the sub-loan. Long-term loan deferments negatively impact a CDFI's lending capacity, especially near-term capacity. Regularly scheduled sub-loan repayments allow a CDFI to lend that money again which will maximize the environmental benefit sustainably overtime.

Security position – The position defines the order in which claims against the security will be satisfied in the event of a foreclosure, default or non-payment. Most lenders prefer to lend only in the first position, but some lenders will go in a "subordinate" position (second, third, etc.) in exchange for a higher rate of return.

DEQ will have first position or parity lien.

DEQ's proposal:
The proposed security position is DEQ's standard business practice. This can include sharing first position with other lenders that hold first position, known as parity, but DEQ isn't willing to be in a subordinate position especially since these loans are not as secure as a public agency loan. Parity lien on a parity basis is when each lien holder gets an equal amount of security in the event of a default.

Loan security – An asset that is pledged by the borrower as protection in case the borrower defaults on repayment. Essentially this is collateral and protects DEQ from a CDFI's default by securing certain assets or pledges for repayment.

DEQ's proposal:
DEQ must secure a loan with pledged assets because the CWSRF is not subsidized for losses. The proposed suite of security options allows for flexibility. DEQ will consider a suite of one or more loan security options (pledges) such as:

- Net assets pledge whether unrestricted or restricted but available for such use, this looks at the CDFI as a whole
- Security interest in sub-loan portfolio
- Security interest in a deposit account such as the loan loss reserve

Other asset pledge acceptable to the department; this could be a letter of credit from a financial institution. DEQ is not a balance sheet funder because DEQ finances projects that cashflow.

Asset to liability ratio (also known as current ratio) **–** Total assets divided by total liabilities. This measures the proportion of an entity's assets which are financed through debt. If the ratio is less than 0.5:1, most of the entity's assets are financed through equity. If the ratio is greater than 0.5:1, most of the company's assets are financed through debt.

DEQ's proposal:
Not to exceed 50 cents on the dollar, which means that a CDFI must have at least 50 cents for every dollar of debt owed. If a CDFI has $1M of debt, a CDFI would need to demonstrate $500,000 of assets in the form of reserves or loss accounts.

Debt service coverage ratio (also known as net income to debt service ratio) **–** A measurement of the cash flow available to pay current debt obligations.

1.25:1 of the net assets of the CDFI's septic system fund, meaning DEQ will look for a $1.25 of cash for every dollar of debt service after expenses.

Loan loss reserve – An amount of funding set aside as an allowance for uncollected sub-loans and sub-loan payments. Appropriate to borrower profile and total of sub-loan portfolio.
DEQ's rationale: A loan loss reserve is necessary for a CDFI to cover its losses because DEQ cannot always know what kind of sub-loans will be issued or what type of losses a CDFI is going to experience. DEQ modeled for a three percent loan loss to determine the lending requirements.

Debt service reserve – An amount of funding set aside as an allowance for uncollected loans and loan payments.
DEQ's proposal: The lesser of 10 percent of the loan principal balance or one year's payments. The reserve is there to support loan repayment to DEQ if the CDFI were to experience a financial hardship. DEQ requires a debt service reserve for all CWSRF borrowers. The debt service reserve on a $1M loan with 50 percent principal forgiveness is approximately $20,000 to $50,000. A CDFI should be able to afford to hold this amount in reserves if they are able to lend in the septic system loan market.

Alternative formats

DEQ can provide documents in an alternate format or in a language other than English upon request. Call DEQ at 800-452-4011 or email deqinfo@deq.state.or.us.