Clean Water State Revolving Fund 2020

Summary

Rulemaking Advisory Committee Meeting #3

Part 1: Wed., Aug. 5, 2020
Part 2: Thurs., Aug. 6, 2020
Virtual Meeting

State of Oregon
Department of Environmental Quality

Clean Water State Revolving Fund
700 NE Multnomah St., Suite 600
Portland, OR 97232
Phone: 503-229-5622
800-452-4011
Fax: 503-229-6124
Contact: Lee Ann Lawrence
LeeAnn.LAWRENCE@deq.state.or.us

www.oregon.gov/DEQ

DEQ is a leader in restoring, maintaining and enhancing the quality of Oregon's air, land and water.

Committee Members in Attendance (via video conference or phone)

Committee Member	Title	Representing
Quinn Andreas		Rural Community Assistance Corp.
Chris Baily	Operations Manager	City of Albany representing League of Oregon Cities
Tom Elliot	Building Energy Analyst	Oregon Department of Energy
Janna Graham	Public Finance Officer	Business Oregon
Karen Lewotsky	Rural Partnerships Director	Oregon Environmental Council
Eann Raines	Conservation Investments Coordinator	Clackamas Soil & Water Conservation District
Jill Rolfe	Director	Coos County representing Association of Oregon Counties
Desiree Sideroff	Consumer Lending Director	Craft3
April Snell	Executive Director	Oregon Water Resources Congress
Chris Thomas	Staff Attorney and Policy Specialist	The Freshwater Trust
Doug Waugh (*present for Part 2 only*)	Finance and Administrative Services Manager	Clackamas Water Environment Services representing Oregon Association of Clean Water Utilities

Committee Members Not in Attendance

Committee Member	Title	Representing
Sarah Absher	Planning Director	Tillamook County representing Association of Oregon Counties
Charlotte Bentley	Community Program Director	USDA Rural Development
RosAnna Noval	Rural Development Specialist	Rural Community Assistance Corp.

DEQ staff attendees (for all or part of the meeting)

Staff Member	Title
Lynn Barlow	CWSRF Program Manager
Trina Brown	Water Quality Administrative Specialist
Kathy Estes	CWSRF Senior Loan Specialist
Jennifer Kenny	CWSRF Program Analyst

Rebecca Kramer	CWSRF Project Officer
Lee Ann Lawrence	CWSRF Program Coordinator, Rulemaking Lead
Chris Marko	CWSRF Program Analyst
Oscar Orejel	CWSRF Loan Specialist

Members of the public

Community Member	Affiliation
Bryan Robinson	City of Springfield

Facilitation Team

Name	Affiliation
Colby Mills	DS Consulting
Donna Silverberg	DS Consulting

Handouts and presentation materials

- Meeting Agenda and Materials

Part 1: Wed., Aug. 5, 2020

Introductions and purpose

The purpose of the third and final meeting was to gather feedback and input from the Rulemaking Advisory Committee members and members of the public about DEQ's proposed Clean Water State Revolving Fund lending requirements as they relate to Community Development Financial Institutions that will be incorporated in Oregon Administrative Rules chapter 340, division 054.

Senate Bill 884 expanded the definition of an eligible CWSRF borrower to include nonprofit CDFIs for the specific purpose of lending to individual septic system owners for septic system repair, replacement, and connection to an available sewer system.

At the first and second RAC meetings DEQ shared known requirements and considerations for further analysis. Since then, DEQ evaluated input from the RAC, the public, Oregon Department of Justice, and a contracted third party financial consultant called PFM. In this final meeting, DEQ presented the proposed lending requirements for RAC consideration and input that could be incorporated into the draft rules.

Rulemaking process to date and next steps

DEQ reviewed the rulemaking process and schedule, starting from spring/summer 2020 with the RAC providing input in developing parameters for lending to CDFIs to inform new and amended rules. DEQ hired PFM financial consultants in summer 2020 to provide additional input into how the new rules can best meet the legislative intent, conform to programmatic standards and mitigate financial risk.

Next steps:

- Oct. 2020 – DEQ will post the draft rules for public comment.
- Nov. 2020 – Virtual public hearing. DEQ will respond to public comments in a final document, the EQC Staff Report, which will document every step of the rulemaking process.

- Mar. 2021 – DEQ plans to present the final proposed rules for adoption to the Environmental Quality Commission, or EQC. The rules will be effective one or two days after adoption.

CWSRF staff are also planning how to implement the proposed rules so that the CWSRF loan program is positioned to accept a CDFI loan application upon rule adoption.

Meeting #3 goals

After background information was provided, the facilitator noted the goals for this meeting were to review and provide input on DEQ's proposed:

1. Below-market interest rates, loan terms and principal forgiveness for CDFIs and CDFIs' sub-borrowers.
2. Limits on how much DEQ will lend annually to CDFIs and borrowing limitations to any individual CDFI
3. Project period for loan repayment
4. Conditions to restructure a loan for a CDFI
5. Risk management and creditworthiness measures
6. Draft Fiscal Impact Statement

Lending to Community Development Financial Institutions: Proposed pass-through lending requirements

Overview

DEQ staff provided an overview of the proposed CWSRF requirements that included input and considerations from the RAC, PFM, other CWSRF programs, and EPA and DEQ subject matter experts. Topics included eligible nonprofit and loan terms, interest rate index and additional subsidization, affordability, annual CDFI lending limits, loan repayment/project completion, risk management and creditworthiness, and non-applicable federal requirements. This information is on the [CWSRF 2020 proposed rulemaking website](#).

The purpose of this presentation was to collect feedback and answer questions from the RAC regarding the updated lending requirements and any new information DEQ provided. RAC members were asked to consider the following discussion questions regarding each proposed requirement:

- Do the proposed requirements adequately safeguard the loan fund's perpetuity?
- Do the proposed requirements ensure affordability for CDFIs as well as sub-borrowers?
- What are other considerations DEQ should consider?

Summary of key points and discussion by topic:

Topic: Eligible nonprofit CDFI borrower and loan terms

- DEQ explained that a CDFI's sub-loans are expected to have the same term as DEQ loans to the CDFI of a maximum 20 years and that loan terms must match. CDFIs can offer loan terms less than 20 years, and DEQ would offer the same term.
- DEQ will ask each CDFI loan applicant to confirm what terms would be applied to their sub-loans.
- DEQ has worked with subject matter experts, including water quality engineers, to calculate the average useful life of a septic system.

- The 20-year maximum loan term is based on the “useful life” of typical septic systems, which can exceed 20 years in some cases as it is dependent on how homeowners maintain their systems. DEQ needs to set an average useful life rather than assess each sub-borrower’s septic system. The variability of “useful life” may need to be reevaluated if DEQ sees a need to adjust the expected useful life.

Discussion

Craft3: There needs to be flexibility to negotiate sub-loans to make sure payments are affordable to the homeowner, and that the loan is paid off in a timely manner. Circumstances may arise, such as COVID-19, which would support the need for flexibility for hardship cases, for example.

DEQ response: Will treat hardship cases the same as other borrower types, and would look to determine issues or trends of non-payment in advance, in order to avoid bankruptcies or loan defaults.

Topic: Interest rate calculation and additional subsidization

- DEQ evaluated various standard interest rates and determined that prime rates seemed to be most appropriate, allowing for affordable rates for CDFIs and sub-borrowers.
- DEQ would expect to see revenues and income from CDFI septic system lending rolled back into the CDFI’s septic system lending program, and evidenced in annual financial statements.
- DEQ defines revenue as principal, interest and fees.
- CDFIs may use loan repayment from sub-loans for administrative and outsourcing servicing if they are expenses related to their septic system lending program.
- DEQ understands the costs of running a loan program, and has worked to reduce the CDFI’s debt service amount so that the proceeds coming back from sub-borrowers to CDFIs will exceed their repayment to DEQ and revolve back into the CDFI’s septic lending program. DEQ clarified that interest on the DEQ loan made to the CDFI would only accrue on the net amount of the loan.

Discussion

Craft3:

- CDFIs access capital at significantly lower rates than a typical prime rate. Half of prime rate from last year, which was 5.5 percent, is very high.
- DEQ’s limit that CDFIs can only charge a maximum of two percent above the cost of funds is inadequate to cover costs for Craft3 and most other CDFIs of which Craft3 is aware.
- Some of Craft3’s terms are lower than the rate DEQ is proposing to charge to CDFIs. This structure doesn’t provide CDFIs with flexibility to offer supportive terms to low to moderate-income households or to consider different terms for households lacking access to credit for other reasons.
- Based on the proposed terms, Craft3 isn’t aware of a CDFI in Oregon that would be able to work a program of this complexity with money of this nature.

DEQ response:

- Sub-loans will not be funded solely by DEQ funds.
- 200 basis points and two percent are the same thing for DEQ. Exactly how it gets written in rule will depend on input from the financial expert at the Oregon DOJ.
- Principal forgiveness is written off at the end of the disbursement period and will never exceed $500,000 in any one funding cycle.
- Federal regulations require that all DEQ funds go into capital costs alone.

General RAC comment: Can fees be added to the sub-loans financed, thus allowing fee income to be utilized toward operating costs of the program?

DEQ response: DEQ is not planning to put limits on fees or fee income but will evaluate fees during the underwriting process to ensure they are reasonable.

Craft3: The state sets limits on what are acceptable APRs, through its consumer lending licensing process, to ensure that lenders are not charging too much for fees.

Topic: Affordability

- DEQ, with input from PFM, determined through a comparison of three scenarios that CDFIs can offer a "DEQ rate plus two percent," ensuring affordability for both CDFIs and sub-borrowers.
- DEQ clarified:
    - Scenarios 1 and 2 include principal forgiveness, while scenario 3 does not.
    - Principal forgiveness is directly tied to the receipt of an annual capitalization grant through EPA. If this grant is rescinded for any reason, principal forgiveness would be eliminated. DEQ has no reason to believe the grant will not be continued.
- DEQ loans cost significantly less than private market loans.
- DEQ will not use federal funds for these loans as there are too many requirements; instead they plan to rely on state revolved funds.

Discussion

Craft3: Principal forgiveness helps to overcome challenges to accommodate nuances and compliance requirements for CDFIs; with this cost of funds as it stands this would not work for Craft3, even with their other capital sources. The prime rate is too high and the cap on the rate is too low. As proposed, the cost of offering these loans is too high; two percent is not enough to cover the cost of delivering such a program, even with additional capital sources.

General RAC comments: The flexibility to offer deferred terms to very low-income households is very important for the CDFIs' septic system lending program to accomplish the overall statewide water quality objectives. There is a need to support low-income borrowers and suggested further conversation is needed on this at a later date.

DEQ response: The CWSRF is a lending program, not a grant program. DEQ expected CDFIs would bring other resources, as needed, to support low-income borrowers.

Clackamas SWCD: Principal forgiveness is very helpful for their septic repair program. It helps make their loans more affordable and provides confidence in repaying DEQ, should any sub-borrowers default or need loan term adjustments.

Craft3: There is a way to make this program work for CDFIs to serve people without access to traditional loans, while having the flexibility to give DEQ confidence that their loans will be repaid and continue to sustain the loan fund. More discussion will be needed off line to do this.

Topic: DEQ's annual CDFI lending limits

- DEQ will set limits on loan and subsidization amounts based on funds available, which safeguards the fund's perpetuity. DEQ runs a loss model scenario annually to determine what the program can lend.
- DEQ's maximum lending limit is $1 million per CDFI per year, with an aggregate for all CDFIs of $5 million per year. This is a cautious starting point and could go up or down based on the portfolio's performance.

- DEQ will score and rank all CDFI loan applications in the same manner current loan applications are reviewed.

Discussion

Craft3: We received just over $1.3 million in loan applications in the first half of this year, and based on EPA data, annual demand from nonprofit lenders for clean water loans is between $2-5 million annually in Oregon. Do not put a lending limit per CDFI in rule, rather give DEQ the flexibility to determine the maximum amount based on underwriting of the CDFIs. Not creating additional administrative burden benefits both CDFIs and DEQ.

Topic: Loan repayment/project completion

- DEQ will set the project period for each new CDFI loan at 12 months because lending to a nonprofit lender is very different from lending to municipalities or water districts.
- All DEQ loans and the CDFI's sub-loans will be fully amortized because EPA requires that DEQ loans be fully amortized. The intention is to create and maintain a fund that will sustainably revolve.

Discussion

Craft3: DEQ should work with CDFIs to come up with a plan with which all are comfortable, again emphasizing the need for flexibility.

Topic: Non-applicable federal requirements

- DEQ noted that the federal requirements cannot be changed except through federal law. EPA generally delegates to states to make decisions related to non-point source pollution controls.
- In terms of comparable state requirements, every state law that is applicable to the septic system program is applicable here, and will be in the draft rules for public notice. DEQ has been looking at wage requirements, which are equivalent, and applicable land use laws.

Discussion

RCAC: These requirements make sense.

Clackamas SWCD: This approach to federal requirements is very helpful to CWSRF borrowers who lend to local borrowers for septic system repair projects.

General RAC comment: This may work well for borrowers, and recommended DEQ adequately explain this requirement during public comment to avoid push back.

Part 2: Thurs., Aug. 6, 2020

RAC member reflections on Part 1

RAC members acknowledged the challenges of DEQ's proposed loan terms while noting that it may not work with all CDFI models, and there is a need for the program to be designed and used by those for whom it is intended.

RCAC: DEQ shared good information; still they are uncertain how much interest CDFIs will have in applying to the program as proposed.

ACWA: Expressed appreciation for CDFIs being the intermediary for these funds. Recommended DEQ build interim rules into the draft rules as a trial run, then do a program and rule review to see if the rules are working as intended for CDFIs after a set period of time.

Business Oregon: The available funds, 1.63 percent plus $500,000 forgiveness, are substantial loan offering for nonprofits and DEQ has done a good job structuring the program.

Clackamas SWCD: Clarified that, in terms of fiscal responsibility, DEQ has done well with disbursing funds to SWCDs, and the disbursements are quick reimbursement of funds spent.

Craft3: It is helpful to differentiate risks from unknowns. Results from DEQ lending to CDFIs are all unknown. As drafted, Craft3 sees the role of CDFIs as insulating DEQ from risks of lending to sub-borrowers. Even if half of the CDFI loans to sub-borrowers go bad, DEQ gets repayment through underwriting. As such, and given the volatility of the times, Craft3 encouraged flexibility be built in to support DEQ's good underwriting process. Finally, Craft3 clarified that there are not many other sources for capital for this kind of work, and that CSWRF is the solution the legislature created.

If DEQ has the flexibility to make terms more affordable, they could become a national leader. Insuring affordability for CDFIs and sub-borrowers is a matter of balancing the risk to the CWSRF with the need to give flexibility for payment options for sub-borrowers. Does the program do everything possible to make it affordable for those who need to make septic improvements, while following the primary intentions of the legislation?

Lending to Community Development Financial Institutions: Proposed pass-through lending requirements (continued)

Topic: Risk management and creditworthiness

PFM and DEQ spent six weeks considering measures that include: security position; loan security; asset to liability ratio; debt service coverage ratio; loan loss reserve; and debt service reserve. As a result, DEQ proposes:

- **Security position**: DEQ must take first or superior position to all other septic program debt, other debt or other reserves. This position does not take into account other loan program debt the CDFI may have, this is septic loan program specific.
- **Loan Security:** DEQ will consider a suite of 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, the value could vary based on the rating of the sub-loans
    - 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

Discussion:

DEQ clarified that securities would be for Oregon debt, not out of state debt. Fixtures are secured, but it doesn't mean that DEQ wants it as security. DEQ has worked to accept flexibility for loan security options.

League of Oregon Cities: Transfer of risk from DEQ to CDFI: Can any of these be dialed back so that DEQ still gets repayments but that the CDFIs can have more flexible terms with sub-loans?

DEQ response: DEQ will confirm that a CDFI is fully solvent before DEQ can loan to them. DEQ sees the measures having flexibility for CDFI creditworthiness and should not be hard to meet. They are not insurmountable for a typical business to meet.

Craft3: CDFIs don't have deposits. CDFIs bring in diverse sources of capital and package them and deliver them as loans that are typically more flexible, inclusive or high-risk than the sources that CDFIs borrow from.

Most CDFIs access debt through general recourse security instruments to their creditors. CDFIs do not pledge specific assets to repay a specific loan. Most creditors prohibit CDFIs from pledging assets. All creditors are in a pool that can get in line should the CDFI have repayment issues. DEQ's proposals are opposite of what most CDFIs are set up to do.

There are ways we [Craft3] could get creative by creating another entity and putting fund reserves there and ask our 50 to 150 other creditors to allow a government entity to have first position on a pool of funds. But doing this for just $1M for this cost of funds is prohibitive. Craft3 has created this type of structure for a $20M loan from USDA because the value of the loan made it worth the cost of carving out a specific entity.

DEQ's risk management measures are really cut and dry and really limit a CDFIs ability to use the money. The proposed rules plus a loan loss reserve and a debt service reserve is a lot for the cost of the money and the size of the loan.

RCAC: We are trying to offer loans to people that cannot access traditional loans, and are in a similar position as Craft3.

DEQ: DEQ's CWSRF loan fund is not a lender of last resort and is not subsidized for losses. By statute, the CWSRF has to ensure loans are fully secured.

Topic: Risk management and creditworthiness (continued):

- **Asset to liability ratio:** Not to exceed 50 cents on the dollar which is fairly generous, which means that a CDFI must have at least 50 cents for every dollar of debt owed
- **Debt service cover ratio** of the net assets of the CDFI's septic system fund:1.25:1, meaning DEQ will look for a $1.25 of cash for every dollar of debt service after expenses
- **Loan loss reserve**: Appropriate to the borrower's and sub-borrowers' profile because DEQ does not know what kind of losses a CDFI will have on the sub-loans. DEQ does want to keep this open so that we can negotiate on something that makes the most sense. But, DEQ will require that the CDFI does protect itself with some type of loan loss reserve.
- **Debt service reserve**: DEQ will require that the CDFI have a debt service reserve for DEQ loan repayment that is the lesser of 10 percent of the loan principal balance or one year's loan payments, whichever is less. This ensures that there is money set aside in the event that the CDFI has a cash flow issue.

Discussion:

Oregon Dept. of Energy: It could be expected that some loans will default due to the high risk population being served. DEQ might want to consider the bad public relations that could come with collecting assets from a CDFI, in the event of a default. Principal forgiveness might help the CDFI set up some of the loan reserves.

Craft3:

- Encouraged DEQ to look more flexibly at the proposed asset to liability ratio. Most CDFI creditors require a 5-1 ratio. Craft3 could not operate with anything less than a 5:1 leverage for that purpose.
- Should expect loan losses on sub-loans. If the CDFIs are not losing any loans, they may be too risk adverse and are not helping the intended audience. Losses should be expected and should be part of the equation. Five percent is reasonable as it means assistance is getting to the people that need it. CDFIs would handle those losses and should demonstrate that DEQ will be paid regardless to losses.
- The underwriting package that most CDFIs provide when requesting a loan provide details to give security comfort to lenders.
- There are more ways for DEQ to accomplish its goals while making sure the sub-borrowers can be served.

ACWA: The market is risky and DEQ shouldn't necessarily expect to get all their money back. The program should be tried out with looser requirements at first to see how repayments are working. If it's too restrictive in the beginning, DEQ won't see loan activity. Balance needs to be struck between DEQ achieving its goal and willingness to risk money versus trying to make sure every dollar gets repaid.

RCAC: A lot of people that need the CDFI loans are low-income people. Concerned that the lower income who tend to be the sub-borrowers who need these funds most will be missed.

DEQ response: DEQ set up these proposed lending requirements to align with the CWSRF's current operating structure and to meet the goal of affordability for the CDFI and sub-borrowers. Under the current CDFI lending proposals, DEQ will rely on other borrowers' fees to offset program costs, making this more subsidized than the average loan.

What did folks imagine the program and requirements would look like, given the intent of the legislation? How low could the program go and what would be a reasonable level of subsidization while also being accountable to maintaining the fund's perpetuity?

Oregon Water Resources Congress: Helping low-income people repair failing septic systems is a perennial issue. These types of projects need subsidization, maybe more subsidized than other classes of projects due to the water quality issues.

LOC: The impact affects the property owner and the greater community. It's not a concern that fees paid by other borrowers would offset the cost of these loans. I can't provide a specific amount that would be viable but it would be good if DEQ sets a review period to see if the intended goal of the rules are achieved.

Craft3:
- Consider the offset cost of dealing with septic failures and water quality problems across the state.
- The issue behind the rulemaking, needing to provide a way for primarily low-income people to upgrade failing septic systems, is a class of projects that warrant subsidization especially in areas where people cannot get onto city systems. If the state doesn't fix the systems, then there will be more widespread, extreme, and costly impacts on others outside of those systems. Agrees there should be a review period to ensure that there are sustainable funds available to support the fund's perpetuity, while having a level of subsidization and investment.

Business Oregon: Is DEQ really the right agency for the legislature to ask to manage a truly viable program for CDFIs? It appears DEQ has put together a program as good as they are able under the parameters set and that they cannot just give money away. Consider asking the legislature for some additional funding to flow through the program to make it viable.

Craft3:
There are ways to make this less costly and more viable for a CDFI that do not include money, such as minimizing administrative costs:

- DEQ could look at more ways to be cost effective within the requirements and program set-up for the benefit of CDFIs, including raising the amount that a CDFI can borrow.
- If money is based on reimbursement, DEQ has control on disbursement, based on borrower performance and use.
- Covid-19 has shown how vulnerable the state's infrastructure is.

Oregon Environmental Council: The challenge of failing septic systems is really an infrastructure conversation. In terms of talking to the legislature, it could be framed as an aspect of upgrading the water infrastructure across the state and could be a way to gain access to more funds for the effort.

Oregon Dept. of Energy: Was in a program that used general obligation bonds for risky loans to finance private efforts and in the end had many losses. In this case, it doesn't sound like DEQ will be able to meet CDFI needs and it is worth going back to the legislature unless DEQ can build in losses.

Oregon Assoc. of Counties: We have to make sure the loan program continues while also addressing the water quality issues caused by septic systems.

RCAC: RCAC's loan specialists expected the same loan terms as Idaho's CWSRF program structure [which has 100 percent principal forgiveness for the CWSRF loan].

Craft3:

- 50 percent forgiveness would work if pricing was different in security requirements.
- The limit on spread of terms to the sub-borrower is a real barrier, as are some underwriting requirements and limitation on rates to sub-borrowers.
- If the rate was one percent to the CDFI or if there was flexibility to go lower for certain populations and adjustment of terms on the sub-loans could make this viable.

Draft Fiscal Impact Statement

The CWSRF 2020 rulemaking draft fiscal impact statement can be viewed in the meeting materials for meeting 3 on the CWSRF 2020 proposed rulemaking website. The fiscal impact statement requires identification of fiscal impacts that may be experienced by state agencies, units of local government, small and large businesses and the public as a result of adopting, amending or repealing any rule. The statement must provide an estimate of economic impacts and a cost of compliance for affected small businesses. If the RAC finds a rule will have a significant adverse impact on small businesses, DEQ will need recommendations on how to mitigate the impact.

DEQ believes there could be many fiscal and economic impacts from the proposed rule changes to DEQ's CWSRF, and they are categorized in the document into direct impacts (borrowers) and indirect impacts (secondary and third degree impacts). The proposed rules are not expected to have an impact on loans to other CWSRF borrowers and prior applicants.

Summary RAC responses to Draft Fiscal Impact Statement

- RAC did not find any additional impacts other than what DEQ had identified.
- RAC did not find any adverse impacts on small businesses.
- RAC members noted that the fiscal benefits far outweigh the potential adverse impacts.

- Craft3 encouraged DEQ to consider:
    - Watershed-wide impacts, not just in the immediate areas of septic issues
    - Determine reduction in staff time required from the rest of DEQ
    - Quantify the options and benefits or impacts to the program
    - DEQ can reduce adverse impacts by making sure that eligible entities are aware of various incentives and ways to score higher on their loan applications, ensure applicants are aware of how they can best rank and put together a project for the loan fund.

DEQ staff will incorporate RAC member responses to the three questions into the draft fiscal impact statement.

Public comment period

There were no comments from members of the public.

DEQ responses to RAC member input

During the meeting, DEQ presented information and listened to open feedback and discussion among the rulemaking advisory committee members. While staff answered questions and made some comments, they did not directly respond to all feedback about DEQ's proposals. The tables below includes RAC feedback on proposed lending requirements and DEQ's responses.

Market rate – Prime rate (3.25 percent at the time of the meetings)
Feedback: • Consider LIBOR rate or the Municipal Bond rate. • Prime rate can be very high and even at 50 percent the rate. CDFIs typically have access to much lower rates.
DEQ's response: 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 **LIBOR:** DEQ does not agree that LIBOR, the rate private banks use to lend to each other, is appropriate for a state agency to use for lending to a nonprofit CDFI. Further, • LIBOR will sunset in 2021 and will be replace by another system, TBD • LIBOR varies daily

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.

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

Feedback:
Limits reduce flexibility and create administrative burden for CDFIs and DEQ. Instead, DEQ should determine the maximum amount based on underwriting of the CDFIs.

DEQ's response:
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)

Feedback:
The two percent above the cost of funds is inadequate to cover costs for Craft3 and most other CDFIs of which Craft3 is aware. Some of Craft3's terms are lower than the rate DEQ is proposing to charge to CDFIs. This structure doesn't provide CDFIs with flexibility to offer supportive terms to low to moderate-income households or to look at different terms for households lacking access to credit for other reasons. Based on the proposed terms, Craft3 isn't aware of a CDFI in Oregon that would be able to manage a program of this complexity with money of this nature.

DEQ's response:
The two percent mark up 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.

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

Feedback:
State of Washington's contract with Craft3 has a three year project period.

DEQ's response:

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

Though DEQ does consult with the State of Washington's CWSRF program and other state CWSRF programs, DEQ has not been directed to adopt other states' requirements.

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

Feedback:
Flexibility to negotiate sub-loan terms should be up to the CDFI and based on sub-borrower affordability.

DEQ's response:
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 (five, 10, 15 years) if the sub-loans also have the same shorter term.

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

Feedback:
The proposed framework could work if DEQ adjusted other terms, rates and security requirements.

DEQ's response:
DEQ's proposed terms, rates and requirements are the most affordable that DEQ can offer while safeguarding the fund's perpetuity and being equitable to other CWSRF borrowers.

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.

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

Feedback:
CDFIs need flexibility to negotiate sub-loan repayment terms to make sure payments are affordable to the homeowner, and that the loan is paid off in a timely manner. Circumstances may arise, such as COVID-19, which would support the need for flexibility for hardship cases, for example.
Other loan deferments allow homeowners to stay in their homes.

The limit on spread of terms to the sub-borrower is a real barrier, as are some underwriting requirements and limitation on rates to sub-borrowers.

DEQ's response:

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 –DEQ will have first position or a parity lien.

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.

Feedback:
Most CDFIs access debt through general resource security interests and do not pledge specific assets to repay a loan, in fact most of Craft3's creditors prohibit that. Every creditor is part of a pool should the CDFI have issues with repayments. So, these requirements are opposite of what most CDFIs are set up to accomplish. Craft3 could set up another entity to meet this requirement or Craft3 could ask their other 50 – 100 creditors if they would allow a carve out for this type of security but it would be prohibitive for just $1M, given the cost of funds.

DEQ's response:
Security position: The proposed security position is DEQ's standard business practice. DEQ will have superior position/first lien, which is supported by statute. 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: 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

Asset to liability ratio –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.

Feedback:
Craft3 encouraged DEQ to look more flexibly at the proposed ratio. Most CDFI creditors require a 5-1 ratio or 10-1.

DEQ's response: 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 – 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
Feedback: This may or may not be workable for a CDFI. It will depend on how it's defined within certain timeframes. Craft3 would not be able to apply under this scenario.
DEQ's response: The proposed DSCR is a standard business practice.

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.
Feedback: There will be loan losses and DEQ should ask a CDFI how they manage it. If a CDFI can guarantee repayment maybe a loan loss reserve wouldn't be necessary. This could be handled in underwriting in a different way.
DEQ's response: 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 – 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 as an organization.
Craft3's feedback: This could be handled in underwriting in a different way.
DEQ's response: 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.

Summary of Next Steps

DEQ acknowledged that RAC input would be a core consideration when making adjustments to the draft rules, along with guidance from the Oregon DOJ.

The public notice of the draft rules includes the steps DEQ took to engage the public and stakeholders. The notice was posted on Oct. 9, 2020 and DEQ will accept public comments through Nov. 23, 2020.

The virtual public hearing on Nov. 17, 2020 will be the opportunity for stakeholders to make verbal comments. DEQ will present the final staff report the EQC in March 2021. EQC has the authority to adopt rules and to pause to make additional recommendations. Once the EQC adopts the rules, they will be effective within one to two days. The CWSRF program will be ready to receive loan applications upon rule adoption.

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.