State of Oregon

Department of Environmental Quality — Memorandum

Date: Jan. 13, 2021

To: Environmental Quality Commission

From: Richard Whitman, Director
Justin Green, Water Quality Division Administrator

Subject: Item G: Clean Water State Revolving Fund Program Update (Informational)
Jan. 21-22, 2021, EQC meeting

Program overview

DEQ began operating the Clean Water State Revolving Fund program in 1991 and has lent $1.41 billion to communities across Oregon. The program is dedicated to working with small communities and on water quality projects that increase financial and environmental sustainability, climate resiliency, and water and energy efficiency.

The program offers below-market rate loans and bond purchases to public agencies for planning, design, and construction of the following water quality improvement projects:

- Wastewater collection, treatment, water reuse and disposal systems
- Nonpoint source water pollution control projects
- Development and implementation of management plans for federally designated estuaries in Oregon (Tillamook Bay and Lower Columbia River)

Eligible public agencies include tribal nations, cities, counties, sanitary districts, soil and water conservation districts, irrigation districts, various special districts and certain intergovernmental entities. "Public agency" for this program is defined by ORS 468.423.

DEQ reviews and scores loan applications three times per year and publishes the loan applications according to EPA regulations in the program's Intended Use Plan.

The Clean Water State Revolving Fund program operates under the following federal and state rules and regulations:

- Title VI of the Clean Water Act (33 U.S. Code §1383) and CWSRF Regulations (40 CFR Part 35.3100)
- Oregon Revised Statute 468.020 and ORS 468.423 – 468.440
- Oregon Administrative Rules Chapter 340, Division 54

Loan Portfolio

Currently, the program has 80 projects (24 loan applications and 56 loans in disbursement) that include wastewater system improvements, irrigation modernization efforts, stormwater management, stream restoration, a local lending program for nonpoint source projects, and estuary management planning. Twenty three percent of current projects address nonpoint sources of pollution.

The program manages about $75 to $85 million in new loan agreements annually and oversees a loan portfolio with an overall value of close to $750 million at any given time. Currently the program has approximately $269 million in the State's treasury to lend. The program disburses loan funds on a cost reimbursement basis as borrowers accrue costs.

The fund issues loans utilizing revolved funds, which are loan repayments and interest earnings, investment earnings on the fund balance in the State's treasury, the EPA annual capitalization grant, and state match funds.

Repayment revenues are the primary source of funds DEQ uses to finance projects. Repayment revenues are projected to grow and meet future demand, indicating that the fund is adequately revolving. Borrowers begin repayment six months to one year after project completion, based on an amortization schedule provided by DEQ. In the next five years the program will receive more than $287 million in principal and interest to revolve into new loans.

Investments:

- Cumulative loans: $1.41 billion
- Current loan applications: 24 = $152,675,656
- Current loan obligations: 56 loans = $336,667,590
- Net Loans Receivable as of 6/30/2020: 184 loans = $499,725,984
    - 137 loans in repayment = $360,037,577
    - 56 loans in disbursement (net accrued receivable) = $139,688,407

Program Budget

The annual administrative budget is about $2.1 million. Since 2004, the program has collected an annual fee of 0.5 percent from its borrowers, calculated on the current unpaid principal loan balance, to pay the program's administrative and operational costs. The program will collect about $1.9 to $2.8 million in fees each year, varying based on loan repayments, for the next five years to support program administration. To fill any administrative budget gap, DEQ may utilize up to four percent of the annual capitalization grant, as allowed by EPA for administrative costs.

EPA has provided an annual capitalization grant to DEQ that has ranged from $14 to $18 million over the last five years. The state must provide matching funds at 20 percent of the grant amount, which is combined with the grant to fund projects. EPA allows up to four percent of the capitalization grant to be used for administrative costs.

The program does not receive any State of Oregon general or lottery funds. In 1993, DEQ began issuing bonds to generate state match for the capitalization grant, and pays the debt service on those bonds exclusively through loan interest earnings. To date, DEQ has paid approximately $125 million dollars in debt service on match bonds. To increase available funds over the longer term, DEQ routinely calls bonds when possible, and in 2017, DEQ began issuing 24-hour bonds to save on debt service.

Sources of funds	Actuals through June 30, 2020	Estimated State Fiscal Year 2021	Estimated State Fiscal Years 2022-23	Totals
Federal capitalization grants	17,949,000	17,952,000	0	513,447,785
State match	0	10,000,000	0	113,384,322
Investment earnings	5,784,134	4,000,000	8,000,000	71,216,046
Loan principal repayments	36,703,025	48,181,481	79,750,831	811,945,476
Loan interest repayments	7,228,873	8,836,829	19,166,992	239,095,421
Total sources of cash	**67,665,032**	**88,970,310**	**106,917,823**	**1,767,041,050**
Uses of funds				
Loans and amendments	85,122,110	0	0	1,415,215,928
Administration expense paid through capitalization grants	0	718,080	3,000,000	13,819,824
Debt service on match bonds	3,893,223	4,199,384	2,645,750	125,908,589
Total uses of cash	89,015,333	4,917,464	5,645,750	1,554,944,341
Sources of cash less uses of cash	-21,350,300	84,052,846	101,272,073	212,096,710
Net available to loan: State Fiscal Year 2021				**212,096,710**

Note: All figures are above in dollars

Rulemaking background

In the 2016 Oregon Legislative session, lawmakers allocated general funds to DEQ to address failing on-site septic systems. Through a competitive grant solicitation, DEQ contracted with nonprofit lender Craft3, also a Community Development Financial Institution certified through the Department of Treasury, to make affordable loans to Oregonians for septic system repairs. The legislature increased grant funding to $1.6 million over several years. These funds were granted to Craft3 and would not need to be repaid.

Since the Clean Water Loan program launched, $3.5 million was invested to repair or replace failing septic systems in 28 Oregon counties. Those investments supported 181 households and treated 23 million gallons of wastewater annually. Due to a funding shortfall, Craft3 is no longer able to offer new Clean Water Loans in Oregon.

In 2019, the Oregon Legislature adopted Senate Bill 884 that amended ORS 468.423 – 468.440 to allow nonprofit Community Development Financial Institutions, certified by the U.S. Department of Treasury, to access Clean Water State Revolving Fund loans for the purpose of re-lending those loan funds to individuals for repairing or replacing a failing on-site septic system, or connecting to an available sewer.

The bill addressed the nonpoint source pollution caused by privately-owned failing on-site septic systems, a leading cause of groundwater and surface water pollution that can endanger the environment and public health. A Community Development Financial Institution, or CDFI, can provide loans to on-site septic system owners to make repairs that can cost as much as $25,000. The focus of the program is on households that do not have access to affordable financing from traditional sources. CDFIs are non-profit institutions that secure capital from a variety of sources (grants and loans) and then re-lend that capital for public purposes including housing and home weatherization.

SB 884 expanded the definition of eligible CWSRF borrowers, to include CDFIs (the CWSRF otherwise lends only to public entities). To implement this legislation, the EQC must amend existing rules and adopt a new rule in OAR Chapter 340, Division 054 to establish the details of this new program, including the terms under which loans will be made to CDFIs. The intent is to enable CDFIs to develop their own self-sustaining lending programs for septic system repairs and replacements, with a focus on getting affordable financing to lower-income households. At the same time, as DEQ's administration of the CWSRF is subject to federal requirements, and as DEQ needs to assure the long-term protection of the fund capital, the proposed rules also must be designed to assure repayment by CDFIs to the fund.

DEQ began the rulemaking process in January 2020. DEQ held three Rulemaking Advisory Committee meetings, developed draft rules and issued a Public Notice to gather stakeholder input. DEQ is currently reviewing and responding to comments received during the public comment period in 2020. DEQ expects to present proposed rules for commission action at the March 2021 EQC meeting.

Lending to a CDFI

This is a new type of lending for DEQ and requires careful consideration to mitigate the risks associated with lending to non-governmental, private entities. A CDFI's mission is to expand economic opportunities for underserved people and communities. Many CDFIs are community development corporations, credit unions and nonprofit loan funders. There are more than 1,000 CDFIs nationally and 18 registered in Oregon. Lending to a CDFI that lends to on-site septic system owners, sometimes called pass-through lending, is intended to allow private individuals access to below-market rate loans.

DEQ currently offers pass-through loans for nonpoint source pollution control projects to public agencies through the CWSRF's Local Community Loan program. The Clackamas Soil and Water Conservation District, also represented on the Rulemaking Advisory Committee, uses DEQ's Local Community Loan to finance on-site septic repairs and conservation projects that also include irrigation efficiency, livestock use exclusion fencing and no-till seed drilling.

DEQ contracted with third-party financial advisor PFM and consulted with other states with similar pass-through lending programs to develop draft rules that would ensure the most affordable option for CDFIs and that the affordability is passed through to the CDFI's borrowers.

The draft rules align with the program's current lending procedures while also addressing the particular issues of risk management and creditworthiness for CDFIs, as opposed to public entities that typically have a tax base. The draft rules also extend a type of additional subsidization (principal forgiveness) to CDFIs that the program does not routinely offer to public agencies. This is intended to enable CDFIs to make sub-loans to lower-income households while also being able to cover their costs of operating a program.

DEQ safeguards the fund's perpetuity by annually setting loan amount limits and amounts for principal forgiveness based on fund availability. This ensures that the fund is accessible and affordable to all eligible borrowers and will continue to be accessible for decades to come. The draft rules for CDFI pass-through lending set the lending requirements, limits, securities and subsidies to ensure affordability while also managing risk as DEQ begins to lend in a new market as outlined in the CDFI Lending Framework, seen in Attachment A.

Key questions for EQC

1. Does the commission need additional information about how the CWSRF loan program operates and the proposed CDFI Lending Framework?
2. Is the distinction between the general fund *grant* that DEQ awarded to Craft3 2016 thru 2019 to operate their on-site septic loan program and the CWSRF *loan program* clear to the commission?

Next steps and EQC involvement

DEQ will present proposed rules for commission action at the March 2021 EQC meeting.

Attachment

A. Proposed Community Development Financial Institution Lending Framework

Report prepared by Lee Ann Lawrence
Clean Water State Revolving Fund Program Coordinator

Interest rate for loans to CDFI
The purpose of the CWSRF is to promote loan affordability by offering "below-market" interest rates. DEQ is likely to propose a rate (or rates) tied to a percentage of the prime lending rate – (currently 3.25%). The rate may be less than 100% of the prime rate, particularly if the CDFI/Borrower agrees to meet metrics tied to sub-lending to lower income households. For the Local Community Loan Program, DEQ uses 50% of the base rate. The Local Community Loan Program is DEQ's other pass-through loan offering.
Maximum loan amount – per CDFI, per year **Total CDFI lending limit per state fiscal year**
DEQ, with input from the RAC and PFM, is likely to propose a maximum lending limit per CDFI per year, as well as an aggregated CDFI lending cap. The purpose of these limits is to reflect that this is a new program with a different set of risks from the SRF's more traditional lending, and that the agency and CDFIs need time to develop expertise and relationships to create sustainable program that delivers financing to households that need it. The proposed rules likely will allow CDFIs to apply for and (if approved) receive a new loan every year.
CDFI rate (on sub-loans)
DEQ is likely to propose a limit or limits on the interest rates that CDFIs charge to borrowers to ensure that loan affordability will be passed on to sub-borrowers. DEQ is exploring whether to also tie rates to the borrower's household income.
Project period (loan disbursement period)
Federal law requires borrowers (in this case, the CDFI) to begin repayment 12 months after the project's construction phase is complete. DEQ will propose how to set the beginning of the loan term, in light of the fact that sub-loans by a CDFI will be over a period of time.
DEQ annual fee
DEQ is likely to propose that the rules include a fee to cover the agency's costs to administer the program.
Maximum loan term
DEQ will propose a maximum loan term. Under federal requirements, SRF loans may not be for a term that exceeds the useful life of the asset being financed. Septic systems typically have a useful life of about 20 years.
Principal forgiveness

Principal forgiveness is used to enhance the affordability of financing. In the case of the proposed CDFI program that means both making the program work for CDFIs as a business operation, and making it possible for CDFI's to offer sub-loans to lower income households at affordable rates. DEQ's ability to provide loan forgiveness is also dependent on ongoing federal support for the program.
CDFI program income/profit
The rules will restrict the use of funds to a CDFI's septic lending program. Many CDFIs are involved in other quasi-public lending, such as for affordable housing and home repair or weatherization.
Loan security
The proposed rules are likely to allow a variety of options for types of security for loans to CDFIs: • 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 pledges, such as a letter of credit from a financial institution.
Risk Management Covenants
The proposed rules are likely to include requirements for CDFI borrowers to maintain at least certain minimum thresholds of financial stability and performance, including: • **Minimum ratio of assets to liabilities;** • **Minimum ratio of current assets to current debt service after expenses** • **Minimum loan loss reserves** • **Minimum debt service reserves**