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Accelerated Loan Commitment in the SRF Program

Overview

To date, many State Revolving Fund (SRF) programs have taken a "Funds on Hand" approach to lending. This means that each funding cycle is based on the funds actually available or on hand at the time project funding is considered. The funds on hand consist of the current year grant award, state match, and any net leveraging funds produced, plus interest earnings and loan repayments net of any bond principal or interest payments.

The commitment of only those funds that are available has been a prudent approach in ensuring that an SRF does not make commitments beyond what it can deliver. However, given that the decision process for selecting projects can take up to a year or more and project disbursements can stretch for up to another 2 to 5 years, SRFs are finding that current lending practices can result in long lag times from the time money becomes available for commitment and the actual disbursement of funds.

The lag time in fund disbursement combined with the steady stream of interest earnings and loan repayments returning to the SRFs has created a situation for many Clean Water SRFs (CWSRF) of having relatively large cash balances and/or undisbursed federal grant, match, or bond funds. To more effectively utilize these excess funds, SRFs have begun to take a much closer look at the availability and use of funds on a periodic basis to allow the accelerated commitment of funds based on projected cash flows rather than just funds on hand. (This approach is consistent with the practices used by private sector lenders, such as banks.) Drinking Water SRFs (DWSRF) may also look to an accelerated lending approach to avoid the situation faced by some Clean Water SRFs.

This paper discusses the use of accelerated lending and presents the use of this approach by two states, California and Oregon.

What is Accelerated Loan Commitment?

Accelerated lending is the commitment of funds to projects based on the expected availability of funds and the demand for those funds (i.e. cash disbursements) over time. To be conservative, accelerated lending relies on some financial cushion in the projections to ensure that the SRF does not become over committed due to unforseen changes in anticipated cash flows.

Tables 1 and 2 present simplified examples of the cash flow differences between the two approaches to SRF lending in making a funding decision for a $20 million loan. Table 1 shows that when using a "Funds on Hand" approach, where the state waits until the fund has a balance sufficient to cover the entire loan, 5 quarters will pass before the funds are available to make a $20 million commitment. Table 2 shows that when an accelerated approach is used, the loan commitment could actually be made in the first quarter due to the expected timing of cash disbursements for the project and future cash inflows. In this example, the project could be funded a full 4 quarters earlier with no adverse effect on the SRF. Applying this concept to real life

Table 1 - Funds on Hand Lending

Quarter	Fund Balance - Beginning of the Quarter	Loan Commitments	Loan Disbursements	Cash Inflows	Fund Balance - End of the Quarter
1	$10,000,000			$1,000,000	$11,000,000
2	11,000,000			2,000,000	13,000,000
3	13,000,000			5,000,000	18,000,000
4	18,000,000			8,000,000	26,000,000
5	26,000,000	$20,000,000	2,000,000	2,000,000	26,000,000
6	26,000,000		3,000,000	1,000,000	24,000,000
7	24,000,000		7,000,000	4,000,000	21,000,000
8	21,000,000		4,000,000	2,000,000	19,000,000
9	19,000,000		3,000,000	3,000,000	19,000,000
10	19,000,000		1,000,000	2,000,000	20,000,000

Table 2 - Accelerated Lending

Quarter	Fund Balance - Beginning of the Quarter	Loan Commitments	Loan Disbursements	Cash Inflows	Fund Balance - End of the Quarter
1	$10,000,000	$20,000,000	$2,000,000	$1,000,000	$9,000,000
2	9,000,000		3,000,000	2,000,000	8,000,000
3	8,000,000		7,000,000	5,000,000	6,000,000
4	6,000,000		4,000,000	8,000,000	10,000,000
5	10,000,000		3,000,000	2,000,000	9,000,000
6	9,000,000		1,000,000	1,000,000	9,000,000

situations can result in funding projects years earlier than under a funds on hand approach, because careful cash flow analysis can ensure that the funds will be available to meet the project disbursement needs when they are requested. Initiating accelerated lending requires detailed projections of cash inflows and outflows. Data considered in making major cash inflow projections include:

- grant awards/cash draws (net of set-asides for the DWSRF)
- state match
- interest earnings
- loan principal repayments
- bond proceeds
- release of debt service reserves
  other cash inflows (transferred funds, fees deposited in loan fund)

Data considered in making major cash outflow projections include:

- disbursements for existing loan commitments
- interest expense
- bond principal repayments
- deposits to debt service reserves
- other cash outflows (transferred funds, administrative expenses in CWSRF)

Once the cash inflows and outflows are identified over time, the net cash (and undrawn grant funds) can be assessed relative to new project commitments. Following this approach an SRF can then evaluate its ability to commit funds to additional projects on its priority list until the projected resources are effectively committed. The analysis of cash flows should specifically exclude funds that will not be available to fund projects.

Both California and Oregon have made the decision to implement accelerated lending systems using the overall approach described above. Their specific experiences are described in the ensuing sections.

CALIFORNIA

California's State Water Resources Control Board (SWCRB) has taken steps to convert their CWSRF to an accelerated lending system due to concern over extremely large cash balances in the CWSRF's repayment accounts. The SWCRB initially attempted to resolve the issue of excess balances by authorizing the commitment of funds up to 125 percent of expected repayment monies for a period of five years. This approach expedited the issuance of loans, but failed to significantly decrease the cash balance available for new loans. While the State recognized that large cash balances provided a benefit of interest earnings, they were concerned that large cash balances might be interpreted as a lack of demand for funds, a situation that was not true.

To better understand and project their cash balance position, California developed a cash flow model. The model can evaluate different federal capitalization levels and allows analysis of three alternatives for maintaining minimal cash balances, thereby ensuring available project funding in the face of unforseen events and/or changes. Figure 1 presents the first of two basic projections from the state's modeling activity. The solid line presents the projected cash balance in the program if California continues to utilize a cash on hand approach to lending. The dashed line shows the reduction in the cash balance if cash flow based lending is employed.

Figure 2 presents the projected cumulative

Figure 1

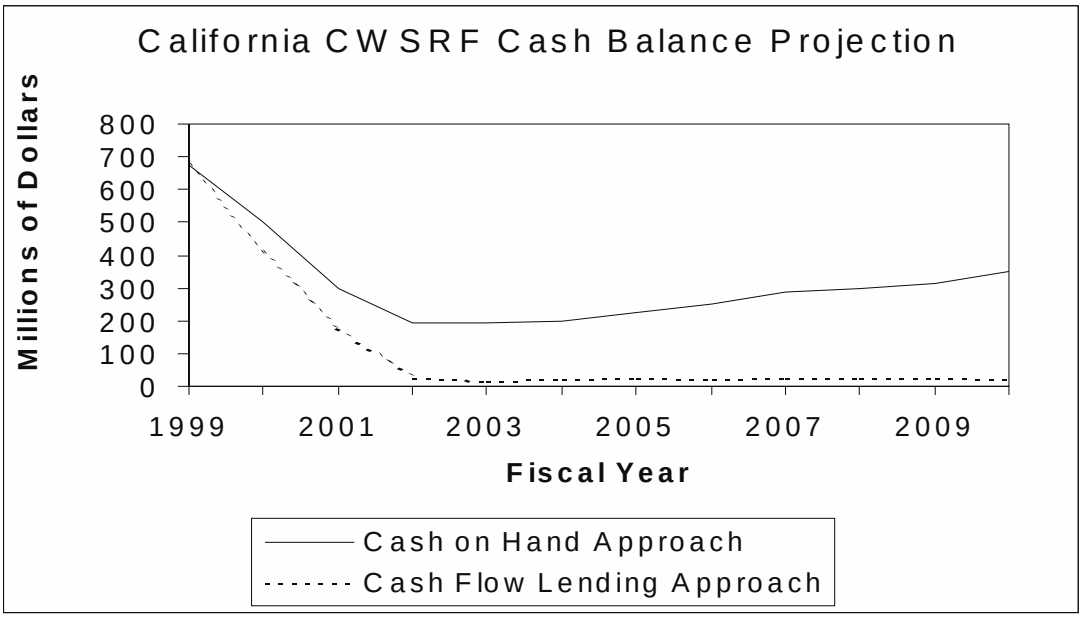
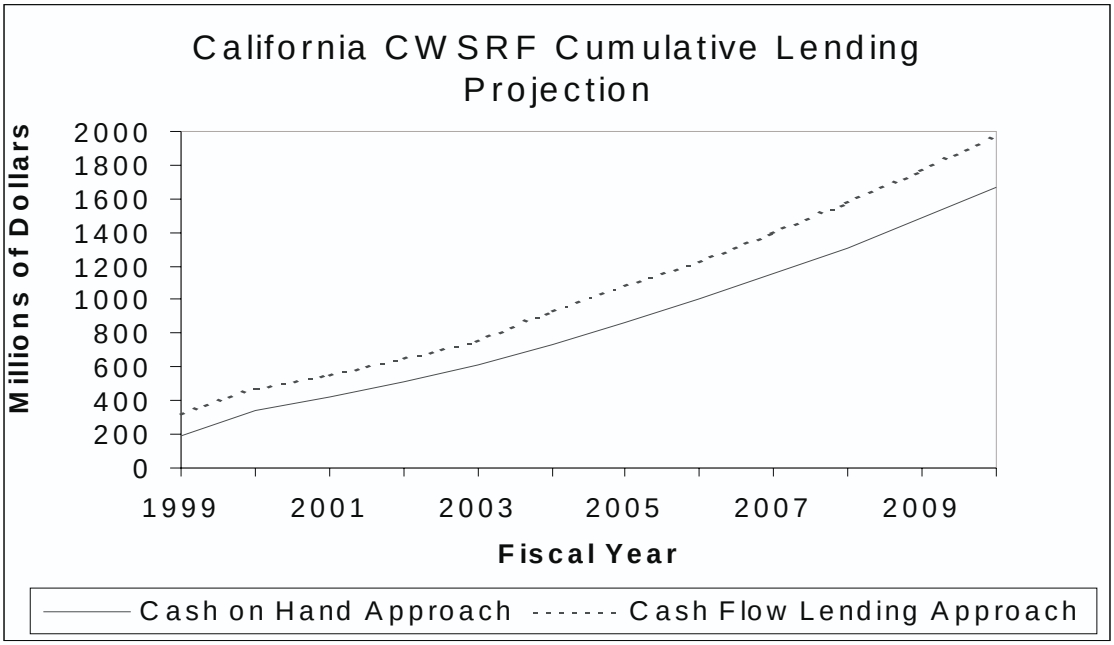


Figure 2



lending activity under the two scenarios of implementation. The $25 million target cash balance that the Board accepted for implementation was a substantial reduction from the cash balance levels of $525 million as of December 31, 1998 ($250 million in undrawn capitalization grants and $275 million in repayment accounts).

California projected that converting to an accelerated approach would result in $140 million in additional loan commitments in the State Fiscal Year 1999 and $210 million in additional loan commitments over the subsequent five years.

The fiscal impacts of the implementation of this system are relatively minor, but worth noting. The system imposes an additional administrative burden for the staff to obtain and monitor payment schedules from present and future loan recipients. Additionally, the CWSRF will grow at a slower rate, due to a lower cash balance earning market interest rates. However, on balance California felt that its most important priorities were to accelerate current loan commitments and demonstrate effective fund utilization by maintaining a significantly lower level of funds on hand.

OREGON

Oregon's Clean Water SRF is a direct loan program that initially only made loan commitments for funds that were actually on hand. However, with delays in project start-up and long disbursement schedules, Oregon's Department of Environmental Quality (DEQ) found that there were long delays from the time when funds were initially available to the point at which project disbursements occurred. This resulted in relatively large cash balances and undrawn grant amounts.

To reduce the lag time in fund utilization, Oregon made the decision to commit more project assistance than it has funds immediately available. By examining the inflows and outflows of CWSRF funds, DEQ discovered that the program could commit to loans in anticipation of future cash inflows as long as it closely monitored the fund's projected cash balance. To monitor the fund's cash balance and to predict the fund's ability to commit to new projects, Oregon created an Excel based cash balance model to track the inflows and outflows of cash in the fund on a quarterly basis. With the spreadsheet, DEQ can predict the amount of new loans that the fund can originate and the effects proposed disbursements would have on the fund's cash balance.

Once the anticipated financial activity has been included in the spreadsheet, the state can evaluate the impact of committing to additional projects on the fund's cash balance based on projected project disbursement schedules submitted by potential borrowers. This becomes one factor the state considers before making a loan commitment. However, this analysis does not supplant either the calculation of funds available, which determines the total amount of loans that will be committed each year, or the priority system which determines the order in which projects are considered for funding.

Other calculations are used to ensure that funds remain available for the highest priority projects when they are ready to construct rather than just going to a project whose disbursement projections fit the cash flow gaps. The state will, on a limited basis, allow for short-term construction period loans when unusual construction schedules create significant periods of time that cash is idle. The cash flow model is most useful in modeling disbursements before a loan is signed to be sure that the cash will be on hand when needed.

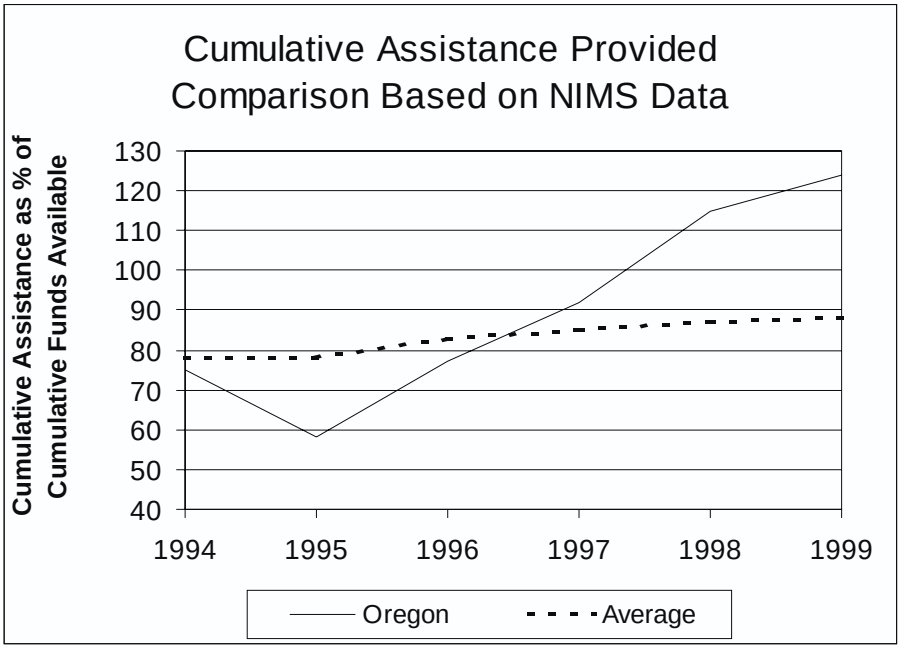
The cash balance projection spreadsheet uses a conservative estimate for potential investment interest and a rapid escalation of administrative expenses to build a cushion against any unforeseen changes in the projected ability to commit funds. As the state gains more experience in projecting cash flows and committing funds in anticipation of funds becoming available, they will be better able to judge the need for conservative assumptions.

A prudent reserve amount is maintained by the State to allow for changes to project schedules, and increases in loan amounts to meet contingency costs for on-going projects. In addition, the state allows for the accumulation of cash to fund large, high priority projects which has the effect of creating continuing cash balances.

Figure 3 illustrates the impact that Oregon's accelerated lending program has had. The figure presents the cumulative commitment of funds as a percentage of cumulative funds available (on hand) for Oregon and all CWSRF programs based on National Information Management System (NIMS) data through 1999.

Through fiscal year 1999, the use of accelerated loan origination has allowed Oregon to commit to $38 million more in projects than they would have committed using the traditional funds on hand approach to loan origination. By completing the loan agreements earlier, projects can meet schedules rather than postpone construction until the funds are available. Program cash is used more efficiently and the state is able to more accurately project the loan funds that will be available in future years. With this information, long-term forecasts are prepared for project management and administration. In addition, changing its approach has allowed the state to commit to short-term loans that provide construction period financing for projects that will receive USDA Rural Development funding. Several projects funded with these short-term loans, totaling over $15 million have kept CWSRF funds in use for communities while other higher priority projects are getting ready for construction.

Figure 3



The accelerated lending approach has become a useful tool for the state's direct loan program, maximizing the use of cash for the benefit of the communities and, essentially, "leveraging" their own cash flow. The approach provides an important piece in using the CWSRF to make the greatest impact possible on water quality programs in Oregon.