Financing Energy Efficiency: Loan Loss Reserves as Credit Enhancements

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Harcourt Brown Energy & Finance

- Consulting firm with a specialty in clean energy finance.
- Domestic and International government, non-profit and private clients.
- Clean energy finance clients include U.S. Dept of Energy, Iowa, Colorado, Michigan, utility, lender, national and regional associations and advocacy organizations.
- Working with these clients to set up or assist in establishing new financing programs.

Loan Loss Reserves: Definition

- Definition: A mechanism whereby a grantee sets aside funds in an account to cover potential defaults on loans.
- Loss Reserves are provided contingent upon availability of funds (eg. 5% of outstanding loans).
  - Guarantees are provided regardless of fund availability. Guarantees are not an allowable use of SEP/EECBG funds.

Loan Loss Reserves: A Type of Credit Enhancement

- Loss reserves are one type of credit enhancement.
  - A credit enhancement is any measure that improves the apparent credit quality, from an investor/lender perspective, of a loan or a portfolio of loans.

Credit Enhancements: Goals

- To attract private capital (leverage)
- To make lenders comfortable with new products or markets
- To attract private lending expertise
- To reduce interest rates
- To create more flexible terms
  - Longer loans
  - Expanded access to borrowing (lower credit scores, for example)

Not the Only Type of Credit Enhancement

- Other examples include:
  - Subordinated Debt: "junior" loans made alongside "senior" loans to fund a project. The "junior" loan might fund 10% of the project costs but also absorb the first 10% of losses.
  - Loan Loss Insurance: Purchased insurance, but not widely used or available
  - Loan Guarantees: Not an allowable use of EECBG/SEP funds.

Some issues to consider:

- Size of loss reserve
  - Depends on the market you're serving
  - Riskier markets=larger loss reserve
- Structure of loss reserve
  - Who holds reserve, interest bearing account, compensation for individual loan defaults, definition of default etc., portfolio vs. individual loans set aside
- Sustainability/replenishment of loss reserve

Sources of Capital for a Loss Reserve

- Must be “concessionary” funds – meaning that if you lose them you may not be happy, but you don’t have to pay them back to anyone else.
  - Borrowed funds are not usually good sources of funds.
- EECBG, SEP, ratepayer funds, other grant funds, lender-borrower-contractor contributions etc. are all good sources.

ARRA Regulations and Context

- DOE Encourages use of ARRA funds as credit enhancements.
- Loss Reserves, Sub/Senior Debt and loss insurance are allowed uses of ARRA Funds.

Who are the lender partners?

- Credit unions: Understand small loans, community-minded.
- Specialty Lenders: Know energy finance very well
- Community Development Financial Institutions (CDFI) lenders: low cost, but limited amounts of capital
- Public lenders (state or municipal bonding authorities such as housing finance agencies): low cost capital availability
- Banks: Both community and national.

What will bring these lenders to the table?

- A market for loans – deal flow. (Many lenders hungry for good quality loans).
- Good quality borrowers with good credit.
- A secondary market for loans (a place to sell the loans). May be important in some cases.
- Credit enhancements.

Issues to Consider with Credit Enhancements

- Make sure that there's a real benefit to the enhancement -- eg. a lower interest rate, more loans.
- Consider ways to customize the enhancement (eg. Reduce reserve size based on improving default rates).
- Find maximum leverage – 20x leverage based on 5% loss reserve isn't unreasonable.
- Pre-agreed underwriting standards are critical. Eg. 680 credit score, 50% debt/income ratio.

Issues to Consider with Credit Enhancements

- Don't give away the farm: a full guarantee may not leave enough "skin in the game" to encourage appropriate underwriting and collections.
- Recommend structuring the enhancement on the basis of total loans outstanding (a portfolio) rather than on a per-loan basis.
  - Eg. A loss reserve set at 5% of total outstanding loan balance, with lenders able to recover up to 80% of the balance of any individual loan in default.
- Reserve levels will vary depending on target market risk. Could be as high as 20% for certain markets served by CDFI lenders.

Structure of Remainder of Webinar

- Julie Metty Bennett: Michigan SAVES
- Brett Johnson, Colorado Governors Energy Office
- Howard Banker, Energy Programs Consortium

Establishing Partnerships with Lenders

Julie Bennett

May 26, 2010

What Is Michigan SAVES?

- Nonprofit organization
- Dedicated to making energy efficiency and renewable energy upgrades easy and affordable for all types of Michigan energy consumers

www.michigansaves.org

Who Manages Michigan SAVES?

- Public Sector Consultants and the Delta Institute administer Michigan SAVES
- Initially funded by a two-part grant from Michigan Public Service Commission
  - Program administration fund
  - Trust fund ($6.5 million)
- Co-PI with the State of Michigan on $30 million Retrofit Ramp-up grant

What Do We Do?

- Provide credit enhancements (reserves and buy-downs) to “qualifying” lenders
- Recruit, qualify, train, and monitor contractors
- Cultivate secondary market and investor interest
- Coordinate with similar and complementary programs
- Sustain and grow the organization
- Evaluate the program

www.michigansaves.org

Critical Partners

- **Lenders**: Provide capital, originate and service loans
- **Utilities**: Service loans, provide customer incentives, conduct measurement/verification of energy savings
- **Contractors**: Market program, assist with loan process, identify needs, and perform work
- **Customers:** Hire contractor, select measures, repay loan
- **Investors:** Provide capital, purchase previously issued loans

Michigan SAVES Lender Partnership Development Process

- Define the market
- Identify lender partner(s) that best serve that market
- Design the loan product and lender requirements
  - Type, amount, terms, rates, eligible properties and improvements, application process, underwriting guidelines
- Design loss reserve terms for loan product
  - Reserve percentage, additions and reductions to reserve, definition of default, claim percentage, maximum contribution, reporting

Homeowner Program

- Loans for eligible energy-saving home improvements performed by Michigan SAVES qualified contractors
- Loans provided by a network of lenders that have agreed to Michigan SAVES program requirements:
  - Unsecured personal loan between $1,000 and $12,500
  - Maximum interest rate of 7.0 percent
  - Term is a minimum of one year for every $1,000; terms extend up to 120 months for loans of $5,000 and more
  - Applications taken through Michigan SAVES application center or directly by lender; loan approval decision provided within seconds
  - Close loan through mail or electronic means; lender services loan
  - Minimum underwriting standards
- Backed by a loss reserve from Michigan SAVES

Homeowner Program Loss Reserve Summary

- Each participating lender has a reserve fund
- Lender's reserve fund starts at $10,000
- After $200,000 in loans are made, reserve fund grows by 5% of each loan
- Reserve fund is reduced as losses are paid out and as loans are paid off (monthly adjustments to 5% of outstanding principal)
- Lenders can claim loss from reserve fund when loans are 90 days past due (80% of loss for FICO 680 and higher, 70% for FICO 640–679)
- $3 million available for establishing reserves. Each lender will receive individual allocation when $2.4 million is committed

Small Commercial Pilot

- Partnership between DTE Energy, ShoreBank Enterprise Detroit (SED), and Michigan SAVES
- Loans for energy-saving improvements in small businesses that provide a community benefit in Detroit
- Loans provided by SED
  - Commercial loans between $10,000 and $150,000
  - Maximum interest rate of 5 percent, 1% or $500 one-time fee
  - Term is based on payback, not more than 7 years
  - Minimum underwriting standards
- Backed by a loss reserve from Michigan SAVES

Small Commercial Pilot Loss Reserve Summary

- Reserve fund is $160,000
- SED will make not more than 10 loans for not more than $320,000 total (50 percent loss reserve)
- SED can claim from reserve fund up to 80% of unpaid loan principal and accrued interest when loans are 90 days past due

Issues/Challenges/Lessons

- A LOAN LOSS RESERVE IS NOT A LOAN GUARANTEE!
- Engage potential lenders in program development
- Reserve percentages are driven by lender-perceived risk
- Use default rates from other similar loan programs when negotiating, but respect lender's familiarity with the market
- When designing loan product, consider secondary market
- Make sure lenders have some skin in the game
- A loss reserve program includes not just the reserve terms, but also designing the loan product, contractor qualifications/monitoring, eligible improvements, etc.

Issues/Challenges/Lessons (cont.)

- Hold the funds until default claim is made (interest helps sustain the fund)
- Describe reserve terms in a legal agreement that references program requirements in a separate agreement (easier to adjust program)
- Be aware of federal anti-trust laws
- Think carefully about structuring loss reserve additions, reductions, and maximums
- Provide an advance for early defaults
- Be aware of due diligence requirements

For More Information

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Governor's Energy Office
Discussion of Loan Loss Reserves
And DOE-Funded Finance Programs

May 26, 2010

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Governor's Energy Office | RECHARGE COLORADO

Summary of Discussion Points

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- First Steps – SEP Funds Initially Designated for a Revolving Loan Fund
- Defining a Leveraged Program Design
    - Three General Components to Program Design
    - Financial Partners
    - Identifying Deal Flow
- Partnership with the Colorado Housing Finance Authority
- Final Program Design, Loan Loss Reserve vs. Direct Lending
- Questions

First Steps – SEP Funds Initially Designed for a Revolving Loan Fund

First Steps – SEP Funds Initially Designated for a Revolving Loan Fund

Evolution of the use of SEP Funds:

•Funds totaling $13 million initially intended for a vanilla Revolving Loan Fund

•October 2009: DOE starts to encourage other forms of leveraging of finance-related funds

•Decision was made to seek innovative ways to leverage funds

Defining a Leveraged Program Design

Governor's Energy Office

RECHARGE COLORADO

Defining a Leveraged Program Design

Three General Components to the GEO Fund Program Design: The Governor's Energy Office had several possible goals for the GEO Fund

•Leveraging Potential

•Speed of Loan Deployment

•GEO Fund Growth, Building a Future Revenue Stream for the Governor's Energy Office

Defining a Leveraged Program Design

Two-Pronged Approach to Program Design:

1. Identifying Financial Partners
   - Venture Capital
   - Investment Banks
   - Commercial Banks
   - Community Development Financial Institutions (CDFIs)

2. Identifying "Deal Flow"
   - Finding markets with true access to capital challenges
   - Finding markets that are replicable

Defining a Leveraged Program Design

Additional Program Design Considerations:

- Leveraging GEO Partnerships and Programs
  - Certain finance partners would not allow us to enhance current partnerships and programs

- Examples of natural GEO Partnerships:
  - EECBG-funded programs such as Main Street and other commercial programs
  - $900k "Governor's Industrial Energy Efficiency Challenge" Energy Audit Program
  - Energy Outreach energy audit programs

The GEO Fund could effectively provide financing options for groups that have access to capital challenges.

Partnership with the Colorado Housing Finance Authority

Governor's Energy Office

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Partnership with the Colorado Housing Finance Authority

Advantages of Partnering with Colorado Housing Finance Authority (CHFA):

- Provides underwriting services that would be much harder to construct under GEO's purview
- Semi-governmental authority provides a quicker contract agreement process
- CHFA and the GEO Fund share similar missions where private lenders might not
- CHFA's management provides a safeguard against future political variables and administration changes

Loan Loss Reserve vs. Direct Lending

Loan Loss Reserve vs. Direct Lending

Remember the three guiding principles of the fund:

1. Leveraging Potential
2. Speed of Loan Deployment
3. Fund Growth and Future Revenue Stream

- A combination of a loan loss reserve and a direct lending format allows to attain all three objectives

- A loan loss reserve and a direct lending vehicle both offer different financing opportunities

- Provides a diversified portfolio of risk and loan opportunities

Loan Loss Reserve vs. Direct Lending

Program Design with CHFA and advantages of loan loss vs. direct lending:

- "Green" Colorado Credit Reserve
  - Provides a 10-20% loan loss reserve match for green loans made with participating lenders
  - Average loan size: $26k
  - Attracts Community Development Finance Institutions (CDFIs) that are perfect for this loan type
  - Leverages GEO small commercial programs

- CHFA Direct Lending
  - Minimum loan size of $100k
  - Loan committee constructed by GEO approves all loans
  - Allows for loans that traditional banks don't currently offer
  - Greater return on investment
  - Larger economic development impact

Questions

Conforming Secondary Market for Residential 1-4 Family Energy Efficiency Loans

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Energy Programs Consortium/National Association of State Energy Officials/
Department of Energy

Energy Programs Consortium

- The Energy Programs Consortium is a joint venture of the National Association of State Community Services Programs (NASCSP), representing the state weatherization and community service programs directors; National Association of State Energy Officials (NASEO), representing the state energy policy directors; National Association of State Regulatory Utility Commissioners (NARUC), representing the state public service commissioners; and National Energy Assistance Directors' Association (NEADA), representing the state directors of the Low-Income Home Energy Assistance Program.
- The purpose of EPC is to foster coordination and cooperation among state and federal agencies in the areas of energy policy and program development.

Program Structure

- Conforming Loan Guidelines and Approved Lenders Across All States
  - Conforming guidelines for loan underwriting, tiered loan pricing ,rules of origination and servicing by experienced lenders or utilities
- PA Treasury Warehouse Facility will purchase loans from approved lenders with Reserves (investments) funded by state/local/utility support
  - Loans are warehoused until critical mass & then sold. During aggregation period loan losses due to default are taken from Reserves held by PA Treasurer

Program Structure

- Secondary Market Sale by PA Treasurer
  - Initial sales using unrated structures until loan level data can deliver rated security offering. Funded Reserves travel w loan assets on sales
- Substantial participation by Foundation PRI's to capitalize additional reserves, reduce public support
- Ongoing analysis of loan performance with local focus allows reduced Reserve requirements for good performance

Program Goals

- Liquid Secondary Market delivers reduced loan pricing to consumers
  - Structure secondary market sales to optimize returns for investors while reducing use of public funds

- Reduces loan rates from 13 – 18% to high 8's
  - Your loan rates can be bought down further to whatever rate you wish to charge. These buy-down costs are reduced by up to 45%

- Deploy funds quickly and revolve funds repeatedly

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