# Arkansas Economic Development Commission - Energy Office

## Loan Loss Reserve Guidelines - 2014

ARKANSAS
Economic Development Commission
ENERGY OFFICE

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## Loan Loss Reserve (LLR) Objective

The Arkansas Energy Office, a division of the Arkansas Economic Development Commission (AEO), is offering a Residential Energy Efficiency Loan Loss Reserve Program ("Program"). The Program will provide funds in the form of a loan loss reserve to qualifying Program Participants ("Participants") across the state that provide residential On-Bill Repayment or On-Bill Financing programs to their customers. The goals of the Program are:

1. For energy providers to encourage residential investments in energy efficiency upgrades or improvements, which reduce energy consumption;
2. Reduce fossil fuel emissions while maintaining service level and delivery to ratepayers, and maximize benefits for local and regional communities;
3. Reduce required energy production in the region through implementation of demand side management; and
4. Improve energy efficiency of ratepayer residential building stock.

### Who Can Qualify for the Program?

AEO defines Program Participants as any (1) municipal utility district, (2) electric cooperative of Arkansas or (3) investor-owned utility (IOU) provider that provide On-Bill Repayment or On-Bill Financing programs to their residential customers (4) any credit union or other capital provider working in tandem with Program Participants.

Funds are available on a first come, first served basis. Applications will be reviewed based on responses to the application questions. Due to limited funding available, Participants will be awarded access to LLR and grant funds on a competitive basis. There is no guarantee of funding.

### Program Funds:

Utilizing American Recovery and Reinvestment Act of 2009 (ARRA) Energy Efficiency and Conservation Block Grant (EECBG- DE-EE000833) and Department of Energy State Energy Program Formula funds (SEP-DE-EE0003777) the AEO will provide:

- Loan Loss Reserve (LLR) in the amount of 10% of the expected total loan fund amount for Program Participants. [1]
  - Example: At 10%, a $100,000 fund has a $10,000 loan loss reserve.

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[1] The ARRA of 2009 appropriated funds for the Energy Efficiency and Conservation Block Grant (EECBG) Program. The Program was authorized in Title V, Subtitle E of the Energy Independence and Security Act of 2007 (EISA), and signed into Public Law (PL 110-140) on December 19, 2007. The State Energy Program (SEP) provides grants to states and directs funding to state energy offices from technology programs in DOE's Office of Energy Efficiency and Renewable Energy.

- In the event of a default Program Participant shall receive up to10% LLR compensation for losses. AEO is not obligated to deposit additional funds in the LLR to cover any additional losses.
- A 1.5 % program processing fee, to be paid by the Program Participant, for each qualified loan is required to enroll into the LLR program. Program contribution fee will be payable to Arkansas Development Finance Authority (ADFA). The program processing fee will leverage administration and processing services.
- In addition, grants funds may be available to leverage the cost of residential energy audits that result in a qualified loan. Grant eligibility is limited to the Program Participants that leverage the cost of the residential energy audit or Program Borrower (residential end-user), when the Program Borrower is responsible for the cost of the residential energy audit. The leveraged grant amount shall be subtracted from program escrow account and shall be limited to $150 per residential energy audit, and will only issue if energy audit results into a qualified loan. These grant leverage dollars will be capped at $20,000 for each Program Participant and $150 per individual residential energy audit.

AEO retains the right to adjust the total funding amount, as appropriate, to achieve the overall goals of this program. The loan loss reserve fund serve are available on a pooled basis and are available on a come first basis. Additionally, AEO retains the right to adjust reporting or program requirements as necessary. However, AEO will communicate changes with participants in a timely and clear fashion. The loan loss reserve funds are available on a pooled basis and are available on a come first basis.

## Energy Efficiency Upgrades or Improvement Program Requirements:

- The upgrades or improvements must provide energy savings or improved energy efficiency and must not be for new construction.[2]
- The program must be limited to residential energy efficiency upgrades within the jurisdiction of the Program Participant entity; and
- Eligible upgrades or improvements must:
    - Be performed in accordance with applicable codes, manufacturers' written instructions and recommendations, industry best practices and standards, and federal, state, and local requirements.

[2] Example of energy efficiency retrofits include: installation of insulation; installation of efficient lighting; heating, venting, and air conditioning (HVAC) and high-efficiency shower/faucet upgrades; weather sealing; the purchase and installation of ENERGY STAR appliances; installation of solar powered appliances with improved efficiency; and replacement of windows and doors.

- Program funds may be used for installation of renewable energy technologies, so long as the primary purpose of the upgrades or improvements are for energy efficiency or energy savings of the building structure to which the renewable energy technology is applied.
- Upgrades must be accompanied by an energy audit and shall include recommendations from that energy audit in loan-funded scope of work.
- All upgrades or improvements assisted through the On-Bill Repayment or On-Bill Financing program must meet quality assurance standards, including contractor certification and energy audit requirements that are consistent with applicable state and federal energy efficiency programs and policies.
    - 5-10% of all projects will be inspected by Program Participant or an appropriate delegate on behalf of Program Participant.
    - Final upgrades or improvements must be accompanied by a certificate of work completion in accordance with the energy audit requirements that are consistent with applicable state and federal energy efficiency programs and policies.
- "Fast track" upgrades include HVAC and appliances. These upgrades do not require a pre-installation audit.
- Program participants shall be required to obtain a utility data release from borrowers that allows for sharing of customer energy savings information between program participant and AEO.
    - Such information will be submitted in an Energy Savings Bi-annual Report showing Program Participants' utility data one (1) year prior to energy upgrade and for up to three (3) years after. Information should be scrubbed of any personal identifying information, but include data on loan size as well as type of energy upgrades that were funded. For additional questions please refer to the Arkansas Economic Development Commission Energy Office.

## What is a Loan Loss Reserve?

Loan loss reserves are the most commonly used credit enhancement, frequently deployed to reduce borrowing costs or extend borrowing terms for Program Participants that would likely qualify for other, often more expensive loan products. Under a loan loss reserve, funds—typically public or utility—are set aside ("reserved") as loans are issued (e.g., 10% of the total portfolio of loans). In this way, a $1million 10% loan loss could provide coverage for a total loan portfolio of $10 million loans. The loss reserve may be specific to a portion of the loss on individual loans. For instance, compensation for losses is limited to 10% of any individual loan, ensuring a natural incentive for lenders to continue to apply appropriate collection criteria to all loans.

Under a loan loss reserve program, funds are placed into an escrow account—either with a separate institution or under their own administration. As loans are made, escrowed funds are transferred to a loan loss reserve fund in the amounts specified by the loan loss reserve agreement. Projects are then completed and loans are repaid over time according to the loan agreement between the financial partner and the borrower. As loans are repaid, funds flow back into escrow from the loan loss reserve in order to maintain the predetermined reserve percentage of the active loan portfolio.

Advantages of loan loss reserve funds include:

- Funds are third-party administered. In this case, the Arkansas Development Finance Authority (ADFA) will act as the administrator of the escrow and accounts for all loans made for Program Participants.
- Programs can utilize the loan loss reserve to stimulate market transformation through development of an energy efficiency financial asset class and eventually function without publicly sourced credit enhancements by proving to lenders that home energy loans can be profitable.
- Providing for an energy upgrade lending mechanism has been shown to directly support utility and program sponsor DSM goals by supporting a higher number of projects of a higher dollar value than in programs without energy lending programs.

Rather than simply lowering interest rates, a few innovative programs are using credit enhancements to incentivize their financial partners to offer energy improvement loans to households that would otherwise not have access to capital.

- Indianapolis (http://energy.gov/eere/better-buildings-neighborhood-program/indianapolis-indiana) is using a large loan loss reserve—with 50% of losses covered—to households in its target income demographic (low to moderate income households)
- The cities of Madison (http://energy.gov/eere/better-buildings-neighborhood-program/wisconsin) and Milwaukee (http://energy.gov/eere/better-buildings-neighborhood-program/wisconsin) used part of their DOE Better Buildings grant to structure a $3 million loan loss reserve to expand access to their loan product. Madison's and Milwaukee's 5% loss reserve reduces potential losses for their financial partner, Summit Credit Union, in the event of loan defaults and supports a loan pool of up to $60 million. It has been structured so that Summit Credit Union can recover more funds from the loan loss reserve on each loan default for lower-credit-quality consumers.

For more information related to loan loss reserves, see Chapter 5 of DOE's *Clean Energy Finance Guide for Residential and Commercial Building Improvements*, "Basic Concepts for Clean Energy Unsecured Lending and Loan Loss Reserve Funds." (http://www1.eere.energy.gov/wip/solutioncenter/pdfs/revfinal_v3ch05basicconceptsdec9.pdf)

## How are LLRs structured?

The Arkansas Energy Office Loan Loss Reserve (LLRs) is characterized by these six main elements:

- "Loss-share" ratio. On any single loan loss, a lender may recover only a percentage of the loss from the LLR, requiring lenders to take a portion of each loss incentivizes financial institutions to lend responsibly.
- A 10% LLR should leverage private capital for energy efficiency upgrades on a 10:1 ratio thereby making available for a $400k LLR, $4,000,000 in LLR backed lending capital.
- A 1.5% program processing fee is required to enroll into the LLR program paid by the Program Participant for each qualified loan payable to the Arkansas Development Finance Authority (ADFA).
    - Program Participants have discretionary authority to recover all or a portion of the program processing fee.
- In the event of a default Program Participant shall receive up to 10% LLR compensation for losses.
- A Program Participant requirements:
    - Program Participant is required to notify the AEO within 60 calendar days after it has defaults all of a qualified loan as a result of default by a Residential Program Borrower. Program Participant shall submit to AEO LLR Claim Application to receive LLR funds. AEO will authorize ADFA to reimburse the Program Participant from the Program Participant Loss Reserve Account within 30 calendar days of receipt of the LLR Claim Application.
- Other Program reporting requirements[3]:
    - Program Participant Monthly Loan Report
    - Program Participant Financial Quarterly Report
    - Energy Savings Bi-Annual Report

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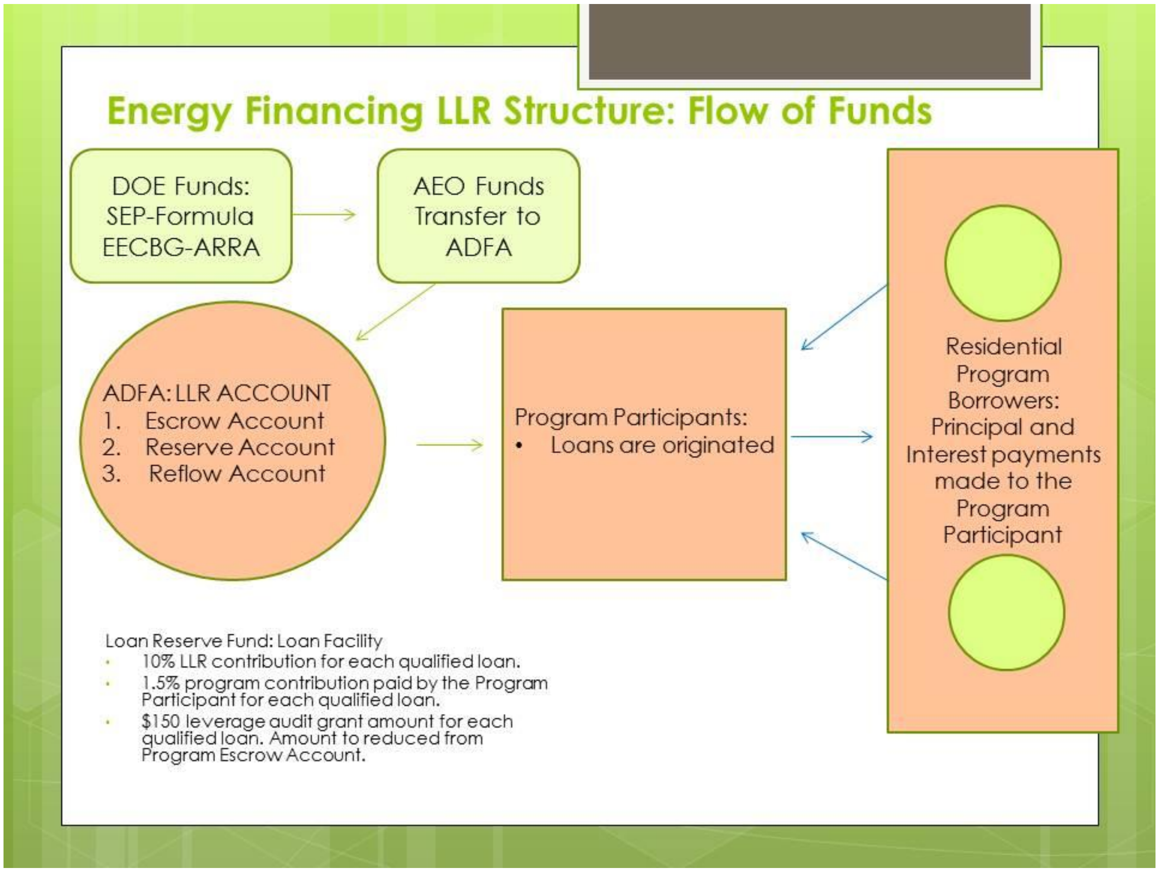
[3] Federal and State reporting requirements are subject to change. Accordingly, Program Participant specifically acknowledges that both it and all sub-contractors will comply with all such requirements during the loan period. AEO will communicate changes to Program Participants in a timely and clear fashion.

## Flow of Funds




## Why have we recommended a loan loss reserve?

- Use public funds to mobilize, leverage, and support the financial investor partner so it will offer, or pioneer and gain experience with, new financing products.
- Broaden access to finance for more borrowers (e.g., homeowners) by allowing the FI partner to modify its underwriting criteria and accept more risk than it would otherwise. Grantees should note that the “risk” might, in fact, be “perceived risk” as opposed to actual and demonstrated risk, due to the FI’s lack of experience with EE lending.
- Lengthen loan tenors (i.e., the timeframe of the loan might be extended from 3 years to 7 or 10 years).
- Reduce loan interest rates, reflecting the lower risk associated with the LLR coverage.
- The LLR supports a clean energy loan program initiated between a government agency (the ARRA grantee) and a financial institution partner (or partners). Other program partners or stakeholders, such as utilities, contractors/vendors, or not-for-profit EE organizations may also be involved

in the grantee's EE/RE program to help coordinate and/or run it—conducting program marketing, installing projects, doing measurement and verification, and more.

## Case Study

**Michigan Saves – Identifying a Gap and Creating a Product**

Michigan Saves (link to: http://michigansaves.org/program/bbfm) is a private, nonprofit entity whose mission is to increase the availability of energy efficiency financing in all market sectors. At its inception, it performed a market assessment to understand the financial products that banks and credit unions offered. The assessment revealed that financing options specifically designed for the residential energy efficiency market were not available. With this knowledge, Michigan Saves decided to create a product with the following attributes:

- Easy to close
- Contractor-centric
- No high fees for contractors
- Attractive interest rates.

During this process, Michigan Saves contacted the Michigan Credit Union League, which helped identify 13 credit unions that helped Michigan Saves design the financial product and process. A loan loss reserve was used to allow its financial partners to offer interest rates in the range of 4-6%. Upon design completion, six of the original thirteen credit unions participated in the program launch; as of early 2014, there are 9 credit unions participating.

Since October 2012, Michigan Saves has closed approximately 3,200 loans with a total value of $26 million. The program approves approximately 80 loans each month. The applicant approval rate is approximately 60% and the average credit score of applicants is 750 for approved borrowers.

## Additional Resources and Program Application

The United States Department of Agriculture (USDA) Rural Development provides a variety of funding opportunities for which Program Participants may be eligible. Program assistance is provided in many ways, including direct or guaranteed loans, grants, technical assistance, research and educational materials. For more information and/or assistance, visit
http://www.rurdev.usda.gov/BCP_FundingForCoops.html

The following DOE templates include details such as loan terms and risk-sharing formulas related to loan loss reserve funds:

- DOE Template Loan Loss Reserve Agreement (link to: C-34; http://www4.eere.energy.gov/wip/solutioncenter/finance_guide/sites/default/files/docs/loan_loss_reserve_agreement_template_1.pdf)
- DOE Template Financial Institution RFP (link to: C-33; http://www4.eere.energy.gov/wip/solutioncenter/finance_guide/sites/default/files/docs/financial_institution_rfp_template_1.pdf

### Program Application

For additional information and application, please visit the Arkansas Energy Office website at www.arkansasenergy.org or call 1-800-558-4567.

Due to the potential size of the application packages, electronic submissions will not be accepted at this time. Applications must be sent by certified mail to:

Arkansas Energy Office
Loan Loss Reserve Program
900 West Capitol, Ste. 400
Little Rock, AR 72201

Notification of funding: After the application is reviewed and deemed complete. Successful Program Participants will be notified of funding no more than 30 days from receipt of application package.

**ARKANSAS**
*Economic Development Commission*
ENERGY OFFICE

900 West Capitol Avenue
Suite 400
Little Rock, AR 72201
800-558-2933

**Residential Energy Efficiency Loan Loss Reserve Program:**
**Participant Application**

Name of Applicant Entity: ______________________________

Address: ____________ City: ____________ State: ____________ Zip: ________

Name of Contact: ____________________ Title: ____________________

Address: ____________ City: ____________ State: ____________ Zip: ________

Phone: ____________ Fax: ____________ Email address: ____________________

**Type of Financial Institution:**

- ☐ Municipal Utility District
- ☐ Electric Cooperative of Arkansas
- ☐ Investor-Owned Utility

-OR-

- ☐ Any Credit Union or Capital Provider working in tandem with a Program Participant

**Program Type**

- ☐ On-Bill Repayment
- ☐ On-Bill Financing

List of the anticipated geographic area(s) by county in Arkansas where the residential energy efficiency program may be available:

____________ ____________ ____________

*For an application to be deemed complete, it must be filled out in its entirety and must include the following:*

**1. Description of the On-Bill Repayment or On-Bill Financing Program including, but not limited to:**

- Program details, such as program name, etc.,
- Potential program participation (total number of ratepayers, members, etc.),
- Summary of eligible energy efficiency improvements or upgrades,
- Maximum and minimum loan amounts,
- Interest rates (whether fixed or variable),
- Loan terms, property type, etc.,
- Underwriting criteria such as FICO score, debt-to-income ratio, etc.

**2. Description of the On-Bill Repayment or On-Bill Financing Program design and processes including, but not limited to:**

- Program marketing and outreach strategy,
- Application process,
- Loan collection and loan default process,
- Description of the Auditor's certification qualification (example: Building Performance (BPI), Home Energy Rating Systems (HERS), etc.),
- Description of how the work will be completed (example: utilizing licensed contractors, in-house crews, etc.),
- If applicable, description of the contractor's qualifications (in addition to legally required licenses).

**3. Describe how the On-Bill Repayment or On-Bill Financing Program will utilize rebates, state rebates, contactor incentives, federal tax credits and/or any available programs to leverage funds:**

- Please provide detail information of the types of rebates, incentives, credits, or other funding sources to leverage funds.

**4. Supplemental Information including, but not limited to:**

- Copy of On-Bill Repayment or On-Bill Financing Program residential loan application,
- Copy of On-Bill Repayment or On-Bill Financing Program Implementation Guide,
- Copy of On-Bill Repayment or On-Bill Financing Program Terms and Conditions,
- Sample copy of proposed Pre-Project Audit, Post-Project Audit, and Certification of Project Completion,
- If applicable, list of proposed contractors.

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Authorized Signature | Printed Name | Title | Date

| Arkansas Economic Development Commission – Energy Office Authority Use Only | | |
|---|---|---|
| Executive Director Approval Signature | Approval Date | Participant ID# |
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