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What Is a Loan Loss Reserve Fund?

And, What Is Its Potential for Financing Low-Income Weatherization?

By Nathan Warren

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Overview

A Loan-Loss Reserve Fund (LRF) is a credit-enhancement mechanism that entices commercial financial institutions to lend capital at a lower-interest rate or with more flexible terms than they might do otherwise. LRFs provide partial risk coverage to third-party lenders in the event of a loan default, making lending opportunities more attractive. The partial risk coverage may motivate commercial financial institutions to offer energy efficiency (EE) and renewable energy finance products, pioneer new products, broaden access to finance and lower interest rates. The partial risk coverage to lenders means that the reserve set up will cover a specified amount of loan losses.

In the difficult economic market, LRFs have the potential to make credit more readily available, enabling energy-conscious individuals to make efficiency improvements to their homes or businesses. The goal is that the loan payments by borrowers will be offset by the projects' energy cost savings. For this reason, it is therefore an important way to leverage public funds with private capital, sometimes resulting in \$10 or more in loan capital available for every \$1 of grantee (i.e., ARRA) money.

While a LRF can be funded with public monies (e.g., ARRA) and can support a range of efficiency and renewable energy finance structures, it is not a permitted use of WIPP funds. Most examples provided herein are not funds WAP agencies can tap for low-income weatherization. However, a LRF might be applicable for creditworthy owners of affordable multifamily housing or Community Action Agencies (CAAs) housing affiliates and Community Development Corporations.

Implementation and Benefits

As aforementioned, a LRF is one among several tools that grantees can use to persuade lenders to provide loaned capital to clean energy projects at a lower interest rate or at more flexible terms than they might otherwise. A central reason why a LRF might be useful for some residential retrofits is the potential for leveraging of other funds it might provide for financing projects that enhance energy efficiency. As an example, by leveraging ARRA State Energy Program (SEP) or [Energy Efficiency Conservation Block Grant \(EECBG\)](#) grantee dollars, a LRF can effectively expand available credit through risk reduction to achieve strong results. Additionally, a LRF is relatively easy to set up and administer. The DOE lists characteristics necessary for the successful establishment and structuring of LRFs. These include a portfolio approach to credit, leverage, a financial institution partner, and a secondary market.¹

Portfolio Approach to Credit

When setting up a LRF, it should be done the basis on the entire portfolio of loans they support. For example, a 5% loss reserve on a \$50 million loan portfolio equals a total loss reserve of \$2.5 million. A LRF structure works best when the target market is a portfolio with a large number of small transactions. For example, typical residential EE loans are in the range of \$5,000–\$15,000 and a typical LRF program will aim to fund hundreds (maybe thousands) of loans. So, a default of a single loan or a few will only make up a small portion of the portfolio.

Leverage

Leverage refers to the amount of private capital that a grantee might attract to a clean energy lending program by offering a loan loss reserve. For example, if a grantee has \$1 million available in ARRA funds for the LRF, a 5% loss reserve will produce \$20 million in capital to lend. Then, the leverage ratio is 20:1.

Lending in residential markets that have low credit quality might require higher loan-loss reserves. For instance, one loan program currently underway in Detroit - [Michigan Saves](#), requires a loss reserve of as much as 50% (only a 2:1 leverage) because borrowers in that program generally have less- than -ideal credit. A higher leverage ratio means that the program can offer more loans than it could with a lower leverage ratio. However, it can also result in less protection against risk for the lender. A lower leverage ratio indicates a greater risk protection for the lender.

Financial Institution Partner

A financial partner can be a commercial bank, a credit union, a nonbank finance company (leasing company or specialized FI), a community development financial institution, utilities, state-chartered (state-level) bond authorities or a combination of the above.

To set up a LRF program, interested entities must identify and research potential partners, obtain a partner, establish a good working relationship, and structure the LRF program with the partner. Different partners have different lending practices and criteria. If the new LRF program can build on the lender's existing loan products (e.g., home improvement loans), then it is likely the partner's new product development process will likely be accelerated, and possibly jumpstarting the LRF program sooner than later.

Secondary Market Support

Some financial institutions, including credit unions, originate and hold residential EE loans in their own portfolio until the loans mature. Other specialized nonbank finance companies, including commercial banks will originate loans, assemble portfolios and then seek to refinance or sell the portfolio to a secondary market capital source. The availability of funds from the secondary market can allow lenders to recycle and relend their loan funds more quickly than they would be able to do if they had to wait for their loans to mature.

Clean Energy Retrofit Loan-Loss Reserve Funds under SEP

A LRF is an eligible use of funds under the State Energy Program (SEP) to the extent that the activities supported by the loans are eligible activities under the program. State arrangements for leveraging additional public and private sector funds, including rebates, grants, and other

incentives, must be arranged to ensure that federal funds are applied to efficiency and renewable measures.

The strength of a LRF is that it may attract funding from multiple sources, spreading the risk and providing more funding opportunities. The leveraging of funds may be accomplished through mechanisms such as partnerships with third party lenders, co-lending, third-party administration of loans, and LRFs. In the example of an ARRA grantee with SEP or EECBG funding, additional potential sources can include local vendors/contractors, utilities (as part of their EE or demand side management program funds), and other donors interested in EE or renewable energy residential improvements.

The use of SEP funds for a LRF is an eligible use of funds if the LRF is in support of a loan made by the grantee or third party lenders that is for the “purchase and installation of energy efficiency and renewable energy measures.” For LRF used to support loans made by third party lenders, the Grantee must ensure the following conditions are met within the [Guidance for SEP on Loan-Loss Reserves](#).

LRFs and Leveraging for Efficiency Projects

A variety of community programs are using EECBG money to fund LRFs. In some cases a LRF can be established and used in conjunction with a municipality’s planned Property Assessed Clean Energy (PACE) program. In the case of the City of Ann Arbor, Michigan, funds for a loan loss reserve fund were budgeted and appropriated from the EECBG Grant. A PACE-type program can allow a municipality to finance voluntary EE improvements to private properties through individual lot or special assessments. With the addition of a LRF, it might allow the City to leverage a much larger pool of private funding (approximately ten times more) for PACE projects and reduce interest rates for participating property owners by covering a portion of delinquent or defaulted payments. Establishing a LRF can be an important step in creating a strong community energy program to meet reduction goals for community-wide greenhouse gas emissions.

In Wisconsin, the [Wisconsin Energy Conservation Corporation](#) (on behalf of Milwaukee, Madison, and Racine), was one of only 25 nationwide applicants to win a competitive [BetterBuildings](#) Grant from the DOE. In the case of the [Wisconsin Energy Efficiency Project \(We2\)](#), a portion of funds from BetterBuildings grant was leveraged to create a LRF to retrofit residential housing. Essentially, this model creates a public/private partnership. The public funds leverage, and support a local credit union (Summit Credit Union) to offer a specialized residential energy-efficiency loan product. The LRF allows the credit union to pioneer a new financial product for other programs in Wisconsin including [Me2](#) and [Green Madison](#). This includes broadening access to financing by modifying loan underwriting criteria, extending loan terms, lower interest rates and increasing the size of unsecured energy-efficiency loans.

Using Clean Energy RLF’s in Your Area for Low-Income Community Projects

A LRF can ultimately be funded with ARRA SEP or EECBG dollars. Weatherization local agencies supporting affordable housing might be able to borrow from established SEP and EECBG LRFs for efficient new construction or for rehab projects extending the usable life of their buildings. Also, they may look to LRFs for credit for energy services small business start-up, expansion,

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and retention. While there is no guarantor, in the case of a local or state government, the limit of liability in providing the ARRA dollars is strictly limited to the amount of money that is applied from the grant.

For EE improvements, a LRF supports a program initiated between a government agency (the ARRA grantee) and a financial institution partner (or partners). Other program partners or stakeholders, such as or not-for-profit organizations (i.e. Community Development Corporations) may also be involved in the grantee's EE or clean energy program to help coordinate and administer it including conducting program marketing and even installing projects, and performing M&V.

Additional activities resources and examples CAAs might want to pursue include the following:

- Review existing energy loan programs in your state and local communities. The [Database of State Resources for Renewable and Energy Efficiency \(DSIRE\)](#) is an excellent resource and provides summary tables by state on existing LRFs under the 'Loan Programs' category; many states and local municipalities have created new LRFs to finance efficiency and renewable energy projects

The following State LRFs specifically address residential loans and have also been highlighted as models by the DOE their EERE WIP TAP Webinar Series:

- [Keystone Help](#) – provides homeowners in Pennsylvania with special financing and rebates for EE improvements; it is an example of a third party program that uses state treasurer funds to capitalize a loan program with the lending supported through a loan loss reserve
- [Michigan Saves](#) – utilizes ARRA funds to provide partnering financial institutions with a loss reserve for loans that finance residential energy efficiency
- [Community Energy Challenge](#) (CEC) – gives Washington residents access to unique financing opportunities and residential retrofit recommendations; preferential term financing is made possible by the use of a LRF and interest rate buy-downs – the [Energy Efficiency Finance Corporation \(EEFC\)](#) (firm that focuses on financing for EE projects) acted as a consultant during the CEC financing development process

Common Issues

A common concern of about this type of credit enhancement is "moral hazard." This implies that if a 100 percent guarantee is offered, will the loans be made without respective prudent underwriting? The LRF structure when implemented properly is designed to balance risk sharing between, for instance, between a local government providing the concessional funds and the commercial financial institution partner. A LRF can be structured to help a CAA to not only arrange its own funds to leverage public funds, but also to broaden access to finance in the way the underwriting guidelines are put together.

Other Resources

[NASEO](#) has some valuable resources on [State Financing Energy Resources](#) related to LRFs. This includes Final DOE LRF Guidance, a model agreement between a state/local government entity and a commercial financial institution (basis for establishing a LRF), and a sample LRF obligation letter to the DOE to authorize to use such funds to create a loan-loss and debt service reserve to support loans to property owners for EE retrofits.

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¹ [Clean Energy Finance Guide, Third Edition; Basic Concepts for Clean Energy - Unsecured Lending and Loan Loss Reserve Funds.](#)