EXPANDING LENDING FOR NON-POINT SOURCE PROJECTS

INTRODUCTION

Potential exists to greatly expand the application of the State Revolving Loan Fund (SRF) to non-point source water quality problems using municipal treatment systems as the borrowing conduit to reach the mainly private community of farmers, growers, developers and home owners. In a cooperative arrangement between an SRF and a municipality, the latter would borrow from the SRF and in turn pass the loan funds on, in a subsidiary lending arrangement, to the non-point source discharger to finance implementation of best management practices. Presumably, the state would lend to the municipality at a very favorable rate which in turn could be passed on to the non-point source borrower possibly even more heavily subsidized by the municipality.

While this conduit arrangement could be used in many circumstances, it will have more application for communities situated on so called Aquality limited@ waters where trade offs between point and non-point sources of discharge have the potential of alleviating regulatory pressure on the community to further limit its treated sewage discharge, saving the municipality millions of dollars in more advanced treatment facilities and operational costs. Cost savings are the main incentive enticing a municipality into becoming a conduit lender. As for the state, the incentives are several fold. First, it holds out the prospect of water quality benefits through controlled non-point source discharges. Second, lending through the municipality effectively insulates the SRF from credit exposure to the uncertain finances of many non-point source borrowers. And, just as important in many states, it provides a means of surmounting state constitutional and statutory limitations on lending state funds to private parties in as much as the SRF loan is to the municipality, not the private non-point source discharger.

BACKGROUND

In the area of water pollution control two phenomena are increasingly in evidence. One is the progressive implementation of the point source regulatory control strategy embodied in the Clean Water Act of 1972 which mandates increasingly rigorous control of permitted point source discharges in order to achieve or maintain ambient levels of quality in a specific water body. Under this strategy, waters determined to be in violation of designated quality standards must be subjected to pollution loading allocations that calculate the amount of pollution discharged from permitted sources and develop reallocations of discharge limitations which, mathematically at least, allow the specific water body to achieve the ambient standard. These calculations are referred to as maximum daily loadings and in the last few years have become the focus of multiple legal and administrative actions aimed either at enforcing the incremental regulatory strategy of the Clean Water Act, or disputing the efficacy of its application to certain waters.

Juxtaposed against this strategy of increased control of permitted point source discharges is growing evidence that rapid urbanization and changes in land use practices throughout the country are accelerating the level of pollution flowing into our streams, rivers and oceans from unregulated and mainly uncontrolled non-point sources, contributing, in many cases, levels of pollution to certain waters that obviate the entire point source control strategy.

In other words, even in the presence of rigid control of point sources, the goal of achieving and maintaining water quality standards may not be attainable as a result of uncontrolled non-point discharges into the same waters. In such circumstances, under the present federal regulatory regime, the only alternative is to clamp-down even more rigorously on the permitted point source discharges which, because of the sheer quantity of discharge from municipal treatment plants, especially those located in urban areas, means the application of costly advanced treatment technologies to the municipal waste stream. Anticipation of the expected cost of this threat to the municipal treatment works is one of the factors contributing to recent efforts by the Association of Municipal Sewage Authorities, the National League of Cities, and other municipal based interests to focus attention on the growing cost of municipal compliance.

NON-POINT SOURCE LENDING

While the Clean Water Act is a point source control statute, the amendments in 1987, creating the SRF loan program, provide that water pollution control problems attributable to non-point sources can qualify for SRF assistance so long as they are identified and included in the state's non-point source management plan authorized under Section 319 of the Act or the National Estuary Program's Comprehensive Conservation and Management Plan referenced under Section 320 of the statute. The Environmental Protection Agency (EPA) has been quite latitudinal in its application of these provisions, providing eligibility to most projects that can be associated with abatement of either ground or surface water pollution or those designed to protect the water resource from deterioration. Examples include such things as manure storage and composting facilities, no-till farm equipment and water conserving irrigation machinery, wetlands restoration and protection, land mitigation banking, stream bank restoration, estuary protections, restoration of submerged aquatic vegetation, control of storm water run-off in unsewered areas, underground storage tank removal, failed septic systems and landfill improvements or closures.

Notwithstanding the above, many state SRFs are restrained from lending directly to non-point source borrowers. Mainly these are private, non governmental borrowers in states were constitutional or statutory provisions prohibit the state from providing direct financial assistance to private parties such as farmers, growers, businesses and homeowners. Still other states have self imposed limitations on the SRF from lending to other than point source discharges. Federal regulations, OMB policy and constraints imposed by Federal tax law on the use of funds from tax-exempt bond proceeds can also make it difficult for a state to lend directly to a private party. Although, it should be noted that SRFs can issue taxable debt not subject to most of these same constraints.

Perhaps more daunting for SRF managers are the different credit considerations that enter into the area of private lending. Basically, it is an area of commercial lending without the assurances of either a revenue stream from user fees or a source of taxes to pledge for repayment. Many state loan programs have been reluctant to take on the potential credit exposure inherent in commercial banking. Those SRFs that finance non-point control measures often structure conduit lending arrangements through state or local governmental entities or commercial banking establishments which serve to insulate them from direct credit exposure. (see Council of Infrastructure Financing Authorities= Monograph No. 10 on ACredit Considerations for Reaching Nonpoint Source SRF Borrowers@)

The SRFs, with EPA support and encouragement, have structured an impressive array of intermediary options designed to provide subsidized loans to private parties for non-point source projects. For example, SRFs in some states loan to other state agencies or authorities which in turn relend to individual property owners; to nongovernmental organizations (NGOs) that relend to individuals; directly to individuals; and to commercial banks that make loans to private parties, including individuals.

This latter approach, termed Alinked deposit@ involving a commercial banking entity, is probably the most comparable to the proposed municipal conduit lending arrangement. An SRF deposits funds in a commercial bank in exchange for a certificate of deposit at a significantly reduced rate which it would otherwise pay. The bank makes loans from the deposited funds to private parties for non- point source projects. The loans are at below market rates with the spread going to the bank. The bank performs the credit analysis, services the loan, and assumes the credit risk.

<u>THE MUNICIPAL CONDUIT</u>

What the Environmental Financial Advisory Board (EFAB) suggests here is not a strategy to further subsidize municipal treatment costs, but rather a means by which municipalities can access low cost financing of non-point source controls through the State Revolving Loan Fund, thus deferring, in certain areas, the time when advanced treatment technologies need to be employed. Comparable with linked deposit programs where commercial banks are making loans from deposited SRF proceeds, the municipality would serve as a conduit, borrowing from the SRF, and, in turn, lending the proceeds of the loan to a non-point source project. The attraction for the municipality in facilitating this arrangement is two-fold.

First, and most obviously, it allows the city, with the application of certain well selected non-point source controls, to claim an off-set to pollution loadings, relieving it at least in the immediate future, from needing to implement more stringent controls on its own discharges. It may be appropriate that non-point source control projects selected by the municipality for loan assistance receive advance approval by the state permit issuing authority.

Secondly, this could be accomplished with minimal cost to the municipal treatment authority. Assuming the SRF cooperates in making the funds available at an attractive rate (including zero interest) they would be working with essentially free money. In contrast to a linked deposit program where the spread between the cost of the SRF deposit and the interest charged on the loan goes to the commercial bank, no spread is necessary with municipal conduit lending, although the municipality may wish to generate sufficient funds to pay their administrative costs. The same subsidy from the SRF loan to the municipality can be passed along to the borrower at more favorable terms than those provided by a linked deposit program.

A small loan origination fee or nominal interest might be charged to the borrower to cover the cost of administering and servicing the loan and developing the loan package. The largest consideration from the city would be exposure to uncertain credits from the non-point source borrowers and possible manpower resource costs in putting the loans together. Because non-point source projects can be difficult to implement, especially where multiple parties are involved, the physical design of the project and development of the loan package could be manpower intensive. On the other hand, the overall cost savings to the municipality of identifying and implementing environmentally strategic non-point source projects with potential to defer or eliminate the need to install additional major advanced treatment, could be tremendous.

In the lending arrangement, the municipality would, in effect, serve as the conduit to the private sector (non-point source) borrower. Borrowing directly from the SRF, the municipality would secure the loan with either a pledge of tax or user fee based revenues, thus insulating the SRF from serious credit exposure. As the direct borrower, the municipality would be responsible for loan repayment to the SRF and any associated reporting requirements including those of disclosure in the event that bond proceeds are involved in the loan. Consequently, the state lender would not be especially concerned with the financials of the ultimate borrower but would in all likelihood want to be assured that the project or projects selected for funding met certain environmental criteria determined capable of accomplishing quantifiable water quality results.

To our knowledge, this particular arrangement for reaching the non-point source through a municipal conduit loan has not yet been employed, but would seem to have attractive potential for some communities faced with prospects of increasing costs for control of non-point source discharges. Indeed, there is nothing we are aware of in the Title VI provisions of the Clean Water Act that would effectively prohibit a state loan fund from designating funds, probably through an advance lending pledge device, that could be drawn on by a municipality to incrementally loan to non-profit sources, thus alleviating some of the administrative work associated with approval of each individual loan by the SRF.

ISSUES

Several issues were raised in the development of this report.

- # Can municipalities lend to private parties, particularly in States where SRFs are prohibited from doing the same thing? The extent of this as an issue will need further investigation, but in those states where such lending is not prohibited, EFAB believes that municipal conduit lending for non-point source projects holds considerable promise as a significant cost-cutting option to achieve water quality goals within a watershed.

- # Can municipalities lend to private parties outside of their immediate political jurisdiction? Again, this is a state by state consideration and legal authorities vary. EFAB is aware of the use of the SRFs as a source of capital to state governments, quasi-governmental organizations, NGOs, and commercial banks for relending to private parties for non-point source projects. It is not aware of any SRF lending to municipalities for the purpose of relending to private parties outside of their political jurisdictions. The municipality might enlist the participation of the county or even a multi-county jurisdiction, if so limited. On this issue, the absence of comprehensive state by state survey information should not deter further evaluation of the merits of municipal conduit lending as an option.

- # Would municipal employees have the requisite skills to perform credit analyses of prospective borrowers? While the answer to this involves a case-by-case determination, it seems likely that a municipality interested enough to serve as conduit and assume the risk of loan repayments to the SRF would ensure that it had available to it the necessary skills for the evaluation of loan applications. Technical assistance from outside sources, including SRF assistance and mentoring, provide other resources to the municipality. Other agencies with experience in credit analysis might prove helpful such as the Department of Agriculture's Rural Utility Service.

RECOMMENDATION

The Environmental Financial Advisory Board recommends that the Office of Water support the demonstration of municipal conduit lending for non-point source projects with one or more SRFs and selected municipalities. At the same time, these demonstrations will shed more light on the above issues and provide the empirical information to properly evaluate the concept and possibly other variations.