



**Office of Inspector General
Western Audit Division**

Special Report

A “BEST PRACTICES” REPORT

***SOUTH CAROLINA
STATE REVOLVING FUND
SUBRECIPIENT LOAN MONITORING***

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Palmetto Tree



South Carolina State Revolving Fund Program Subrecipient Loan Monitoring

PURPOSE

The EPA Office of the Inspector General (OIG) has implemented a new reporting program known as "Best Practices." Best Practice reports are intended to highlight certain procedures or activities that deserve special recognition because of the efficiency in which the activity is done or effectiveness of the activity. By making such information available, management of other agencies may be able to improve their own operations by using all or part of the practice.

We recently completed an audit of the financial statements of the South Carolina State Revolving Fund Program (the Program) as of June 30, 1999, and issued our reports on the financial statements, internal controls, and compliance with laws and regulations applicable to EPA's State Revolving Fund (SRF) program as of April 28, 2000. During the course of our audit, we identified South Carolina's subrecipient loan monitoring program as a Best Practice that should be recognized as a comprehensive system that other states may wish to follow to strengthen their monitoring of SRF loans.

INTRODUCTION

South Carolina's SRF Program is jointly administered by the State's Department of Health and Environmental Control (DHEC) and the South Carolina Water Quality Revolving Fund Authority, through the State Budget and Control Board's Office of Local Government (the Office of Local Government). DHEC is responsible for administering the technical and program activities of the SRF Program, and the Office of Local Government is responsible for all financial and management functions, including credit approval and loan monitoring. The joint administration of the SRF maximizes the strengths and expertise of both DHEC and the Office of Local Government.

Almost all SRF loans in South Carolina are secured solely by revenues generated by the utility systems. Therefore, making good credit decisions and actively monitoring loans is particularly important for South Carolina's SRF program. Credit decisions begin with an analysis for the loan approval process and end with the loan repayment. However, the process involves the following major stages:

Credit analysis - Determining the current and future financing needs of the borrower; how these needs can be met and repaid; and the key factors critical to repayment.

Loan Structuring - Determining how to best structure the loan to meet the borrower's needs while meeting legal requirements of the SRF and minimizing risks to the SRF.

Loan Monitoring - Designing a system to monitor and control the credit and risk factors throughout the life of the loans.

South Carolina has taken a unique approach by combining these three distinct stages within the Office of Local Government. As a result, the same staff who review and approve the credit application take an active role in structuring the loan and monitoring the financial condition of the borrower during the life of the loan. Further, South Carolina's active loan monitoring far exceeds what is required by EPA, and attempts to predict problems with borrowers before they arise as opposed to reacting to problems after they occur. These efforts have resulted in a loan portfolio that is financially sound, and provides an acceptable return to the SRF.

The following sections detail how the loan monitoring and credit analysis systems work, and what sets South Carolina's efforts apart from other states.

BACKGROUND

Title VI of the Federal Water Quality Act of 1987 (the Act) established the State Revolving Fund (SRF) program to replace the wastewater treatment facilities construction grants program. Instead of grants, the SRF provides capital to the states to make loans to local governments for constructing traditional wastewater treatment facilities. The SRF can also fund other projects such as nonpoint source pollution control facilities and estuary management plans, and can also provide financial assistance other than loans, such as refinancing existing debt, or providing security on bonds and other debt. Congress intended for the SRF to be a flexible program that allows each state to tailor the program to meet its particular needs. As a result, EPA regulations do not specify detailed program requirements, but provide fairly broad guidelines to make sure that SRF projects are used to provide environmental benefits.

Federal programs always contain a number of compliance requirements that must be followed to ensure that funds are used as intended and that the funds are managed properly to protect the Federal government's interest in the program. Specific compliance aspects of the SRF program include requirements covering:

- Separate accounting;
- Limitations on administrative expenses paid with Federal funds;
- State matching;

- Entering into loan commitments within 12 months;
- Cash management and financial reporting requirements, and;
- Subrecipient loan monitoring.

While states are required to monitor loans made to borrowers, the regulations do not specify how monitoring is to be done, or what steps states must follow to comply. Therefore, there is a wide variety of monitoring done by the SRF's throughout the country. Some states consider monitoring to consist of reviewing reimbursement requests as they are received from the borrowers, while other states require audited financial statements to be submitted. South Carolina has combined its credit analysis and loan monitoring programs into a program that ensures that all borrowers are capable of repaying the loan, and also tracks the financial condition of the borrower to receive early warning in the event of changes.

CREDIT ANALYSIS:

South Carolina has developed a two-phase credit evaluation system that it uses to analyze potential loan recipients. Phase one is a preliminary credit evaluation to determine whether the applicant will be able to qualify for a loan of the desired amount. This phase includes a review of preliminary plans and specifications, project cost breakdown, feasibility studies, financial projections for the completed project, and an analysis of the borrower's most recent budgets, financial statements, bond ordinances/resolutions, and rate structure.

Various factors are considered during the preliminary credit review. These factors include the feasibility of the project, the community's financial condition, its ability to cover its existing and potential debt payments, current and projected user rates, other revenue sources and the economic stability of the community.

While the Office of Local Government has final responsibility to determine whether the loan applicant's credit history and security is sufficient to be able to approve the loan, it works closely with DHEC on the project cost estimates and the economic pro-formas for the proposed project. In some situations, projects are modified so the loan applicant can handle the project and still meet the minimum credit requirements. The cooperative approach of DHEC and the Office of Local Government has resulted in a number of projects being funded that would not have been approved as originally submitted.

Applications passing the preliminary credit review move on to the second phase of the credit approval process. Borderline applicants are advised of their status and are free to continue in the process if they so choose, with the understanding that the Office of Local Government has concerns that need to be addressed. There are no guarantees at this

point that any of the projects will be granted a loan. That decision only comes after a more detailed final credit evaluation is completed.

Phase two of the credit evaluation takes a closer look at the project and the borrower. Staff from the Office of Local Government and DHEC may visit with community leaders, engineers, project managers, local industries and others to determine the most feasible project for the community. One of the most serious areas of risk exposure for a project is to be left with insufficient funds to complete the project. Consequently, plans and specifications are reviewed together with the project budgets to ensure that there are sufficient funds to complete the project. Any changes in the scope of the project will be included in this review.

The Office of Local Government also completes a more extensive analysis of the financial status of the applicant. This will include additional financial information such as the last four years of financial statements (audited, if available), detailed debt information, budgets, system data, local economic characteristics and other information deemed necessary. Staff will prepare ratio and trend analyses, projections, review rate structures, and review the local industry information to determine the borrowers ability to repay the loan. South Carolina is a rural state, and the economy in a number of communities may be heavily, sometimes solely, reliant on a single employer or industry. In such cases, special emphasis is placed on this during the review.

While all applicants are subjected to the preliminary credit review, communities with existing loans that are being repaid according to the loan terms can quickly pass through review process. For those communities, the credit analyses will simply be updated to ensure that the community can repay the increased debt service.

LOAN STRUCTURING:

Having completed a thorough credit analysis of a prospective borrower, the Office of Local Government structures a loan to best meet the needs of the borrower while insuring compliance with laws and regulations and repayment of the loan. The type of loan structure depends to some degree on the conclusions drawn from the credit analysis. For instance, on loans made to "borderline" communities, quarterly financial reporting is often required. In cases where a local business or industry is a major user of the project, a guarantee or other credit enhancement from the business may be required.

The structure of the loan establishes the expectations and responsibilities of both the SRF and its borrowers. It defines the project to be funded. It establishes the costs and availability of funding, federal and other requirements imposed on the project, loan covenants such as debt service coverage requirements that must be met, and continuing repayment and reporting requirements of the borrower. The loan structure is documented in the loan agreement entered into between the borrower and the SRF.

LOAN MONITORING:

South Carolina monitors loans made from the SRF during the repayment period as well as during construction. The State does this to ensure that the loan is being used for eligible purposes, the quality of the loan will be maintained in the future and its repayment sources are protected in order to guard against unacceptable deterioration of the credit and the corpus of the SRF. Should a borrower show signs of such deterioration, the State should be able to take action before a loss would result.

The Office of Local Government uses various means to monitor loan recipients. All loan agreements require borrowers to submit audited financial statements. The audited financial statements are analyzed to make sure that the community still meets the established debt coverage, and that nothing has changed that would affect the community's ability to repay the loan. A financial database is prepared that calculates and tracks a variety of key ratios and financial trends for each borrower. The database is also used to make projections for the next four years, and when actual information is received, is compared to the projections.

By continuously monitoring the financial condition of the borrower and making projections, program management can anticipate how potential changes may affect the borrower's ability to repay the loan. Such projections help provide sufficient time to meet with the community and discuss possible courses of actions that will prevent problems in meeting the obligation.

Loans that are made to communities determined to be "borderline" are reviewed more often. The weaker loans are monitored in much more detail, often requiring quarterly submissions of financial data. Loans that are highly dependent on major businesses or industries are will also be required to submit system usage and revenue data for those key customers.

SUMMARY

We found South Carolina's loan monitoring system to be a prime example of how to evaluate credit of loan applicants, and how to monitor the financial situation of borrowers. The state is to be commended for implementing a program that serves as a model for other states.

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