U.S. DEPARTMENT OF COMMERCE
ECONOMIC DEVELOPMENT ADMINISTRATION

Revolving Loan Fund Risk Analysis System
Final Measures

March 16, 2018

I. BACKGROUND

This document announces the final measures that the Economic Development Administration (EDA) will use for its Risk Analysis System (RAS) to oversee and monitor the Revolving Loan Fund (RLF) Program. The Risk Analysis System, which is designed to provide more efficient and effective oversight of the RLF Program, will be used by EDA to assess RLF awards based on the fifteen measures described herein.

EDA recently published a final rule, effective January 2, 2018, amending the agency's regulations implementing the Public Works and Economic Development Act of 1965 (PWEDA).[1] Among other things, the final rule furthered EDA's efforts to evaluate, monitor, and improve performance within the RLF Program by establishing the Risk Analysis System, a risk-based management framework, to evaluate and manage the RLF Program. Previously, EDA applied a limited compliance-based approach to determine whether RLF Recipients adhered to regulatory requirements and fulfilled the terms of RLF awards. RLF Recipients found to be non-compliant were subject to possible corrective action plans (CAPs), sequestration, and termination. In transitioning to the Risk Analysis System, EDA is modeling its oversight of RLF awards on the Uniform Financial Institutions Rating System, commonly known as the CAMELS (for Capital, Assets, Management, Earnings, Liquidity, and Sensitivity) rating system, which has been used since 1979 by a number of Federal agencies to assess financial institutions on a uniform basis and to identify those in need of additional oversight. The Risk Analysis System uses a set of measures that generally examine these same components applied in CAMELS. However, EDA has developed a modified approach to accommodate the unique goal of the RLF Program as a driver of critical economic development, particularly within distressed communities. In addition to assessing RLF Recipients based on metrics for capital adequacy, asset quality, management capability, earnings, and liquidity, EDA will examine strategic results of the grant award.

EDA will calculate a risk rating for each RLF award by applying the Risk Analysis System to data reported by RLF Recipients through the standard RLF Financial Report (Form ED-209), audits, and other submissions. Specifically, EDA will assess each RLF award against the fifteen measures to evaluate each RLF award's capital, assets, management, earnings, liquidity, and strategic results. This approach will provide EDA with an internal tool for assessing the strengths and weaknesses of each RLF award and for identifying RLF awards that

[1] Economic Development Administration; Revolving Loan Fund Program Changes and General Updates to PWEDA Regulations, 82 Fed. Reg. 57,034 (Dec. 1, 2017) (codified at chapter III of 13 CFR).

require additional monitoring, technical assistance, or other corrective action. It will also provide RLF Recipients with a set of portfolio management and operational standards to evaluate their RLF awards and to improve performance. EDA believes this new Risk Analysis System will provide greater flexibility by assessing each RLF award's strengths and weaknesses under their own specific circumstances, and the resulting information will be used by EDA to prioritize and focus EDA resources to those RLF awards with substantial challenges.

Concurrent with the final rule, EDA published draft measures for the Risk Analysis System in order to solicit and invite public comment on the draft measures.[2] Although EDA received a total of 78 comments, most of the comments related to EDA's regulations or EDA's implementation of the Risk Analysis System rather than the measures themselves. EDA's responses to comments germane to the draft measures are included in Part III.

After careful consideration of the comments received, EDA has made two small but substantive changes to the draft measures. The changes include expressing the Loan Write-Off Ratio measure as a percentage rather than as a ratio and revising the Leverage Ratio measure to clarify that it assesses "required leverage" rather than a two-to-one leverage requirement since leverage requirements may vary in exceptional circumstances. Additionally, EDA has reordered some of the measures and made several clarifying edits. Note that EDA plans to closely monitor and assess the Risk Analysis System, especially during the initial implementation phase, and it is possible that in the future EDA will make small changes to the measures and eventually weigh some measures more heavily than others in calculating the risk rating. However, EDA values consistency and fairness in evaluation, and any future changes to the Risk Analysis System will be gradual and carefully considered.

For more information about the Risk Analysis System, including scoring, implementation, and performance improvement, please see EDA's notice in the *Federal Register* for the draft measures of the Risk Analysis System, which was published on December 1, 2017, and is available on EDA's website at https://www.eda.gov/rlf/ and in the *Federal Register* at 82 FR 56,942.[3] Additionally, EDA will provide further information to RLF Recipients as the Risk Analysis System is implemented in the coming months.

[2] Economic Development Administration; Implementation of Revolving Loan Fund Risk Analysis System, 82 Fed. Reg. 56,942 (Dec. 1, 2017).
[3] Id.

II. The Final Risk Analysis System Measures

These measures are calculated using information from the revised RLF Financial Report, Form ED-209. Where applicable, the measure's formula is presented using references to lines in the revised ED-209.	**SCORE**		
	3	**2**	**1**
<u>Performance Metric: Capital</u> *The RLF Capital Base is expected to increase over time in order to sustain lending activity and to carry out the purpose of the RLF Program. In addition, sufficient capital is necessary to protect the RLF from potential loan losses.*			
Measure: Capital Base Index			
Determined by: RLF Capital Base divided by the original RLF Capital Base at the time the RLF was established *ED-209: II.C.6 ÷ II.A.3*	Greater than 1.5	From 1.0 to 1.5	Less than 1.0
<u>Performance Metric: Assets</u> *An RLF Recipient must adhere to prudent lending standards to safeguard the quality of the loan portfolio.*			
Measure: Default Rate			
Determined by: RLF Principal Outstanding for Loans in Default divided by RLF Principal Outstanding for Total Active Loans *ED-209: III.A.3, RLF Principal Outstanding ÷ III.A.4, RLF Principal Outstanding*	Less than 10%	From 10% to 20%	Greater than 20%
Measure: Default Rate over Time			
Determined by: Number of consecutive months where default rate is over 20%	Less than 12 months	From 12 to 24 months	More than 24 months
Measure: Loan Write-Off Ratio			
Determined by: The number of loans written-off divided by the number of "inactive loans" (calculated as number of total loans minus number of active loans) *ED-209: III.A.5, Number ÷ (III.A.7, Number – III.A.4, Number)*	Less than 16%	From 16% to 25%	Greater than 25%
Measure: Dollars Written-Off			
Determined by: Loan Losses divided by the difference between Total RLF Dollars Loaned and Total RLF Principal Outstanding *ED-209: III.A.7, Loan Losses ÷ (III.A.7, RLF $ Loaned – III.A.7, RLF Principal Outstanding)*	Less than 10%	From 10% to 20%	Greater than 20%

<table>
<tr><td colspan="4"><u>Performance Metric: Management</u>
It is critical to the success of the RLF that Management is experienced with the EDA RLF Program, their RLF Plan, and reporting requirements. Critical positions include: Executive Director, Lending Director, Finance Director, and Reporting Official. Vacancies in any of these positions can lead to program neglect and result in late reporting, weak loan generation, and accounting errors.</td></tr>
<tr><td colspan="4">Measure: RLF Plan</td></tr>
<tr><td>Determined by: Updated RLF Plan</td><td>RLF Plan up to date</td><td>RLF Plan out of date, update submitted within 6 years</td><td>RLF Plan expired and not updated within the last 6 years.</td></tr>
<tr><td colspan="4">Measure: Financial Control</td></tr>
<tr><td>Determined by: Number and magnitude of audit findings</td><td>No findings</td><td>Minor findings</td><td>Material findings, for example Questioned Costs, Insolvency, Interrelated party transactions</td></tr>
<tr><td colspan="4">Measure: Timely and Complete Reporting</td></tr>
<tr><td>Determined by: Date audit and/or additional reports (such as SF-425 or Corrective Action Plan) submitted to EDA</td><td>On time</td><td>Up to 30 days late</td><td>Over 30 days late or no receipt</td></tr>
<tr><td colspan="4">Measure: Tenure</td></tr>
<tr><td>Determined by: Shortest tenure of Executive Director, Lending Director, Finance Director, and Reporting Official</td><td>Greater than 3 years</td><td>From 2 to 3 years</td><td>Vacancy or less than 2 years</td></tr>
<tr><td colspan="4">Measure: Financial Reporting</td></tr>
<tr><td>Determined by: Date RLF Financial Report (Form ED-209) submitted to EDA</td><td>On time with no corrections needed</td><td>Up to 60 days late and/or returned to RLF Recipient for minor corrections</td><td>More than 60 days late; or sent back for major revision</td></tr>
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<tr><td colspan="4"><u>Performance Metric: Earnings</u>
An RLF Recipient is expected to manage costs and generate income in order to increase the RLF's Capital Base.</td></tr>
<tr><td colspan="4">Measure: Net RLF Income</td></tr>
<tr><td>Determined by: Portion of RLF Income Used for Administrative Expenses divided by Total RLF Income</td><td>Less than 50%</td><td>From 50% to 100%</td><td>More than 100%</td></tr>
</table>

ED-209: II.B.7 ÷ II.B.6			
<u>Performance Metric: Liquidity</u> *RLF Recipients are expected to keep a robust lending pipeline and maintain cash within a range of the Region's average cash as a percentage of the Capital Base.*			
Measure: Cash Percentage			
Determined by: RLF Cash Available for Lending (Net of Committed RLF $) divided by RLF Capital Base compared to regional ACP (ED-209, Line IV.D.1) *ED-209: II.D.4 ÷ II.C.6*	Less than 90% of the ACP	From 90% to 110% of the ACP	More than 110% of the ACP
Measure: Cash Percentage over Time			
Determined by: Number of consecutive months where the Cash Percentage exceeds the Region's Allowable Cash Percentage	Less than 12 months	From 12 to 24 months	More than 24 months
<u>Performance Metric: Strategic Results</u> *The purpose of the RLF Program is to provide regions with a flexible and continuing source of capital for creating and retaining jobs and inducing private investment that will contribute to long-term economic stability and growth.*			
Measure: Leverage Ratio			
Determined by: Total Dollars Leveraged divided by RLF Dollars Loaned *ED-209: IV.E.1, Total Loans ÷ III.A.7, RLF $ Loaned*	Meets or exceeds required leverage	N/A	Less than required leverage
Measure: Cost per Job			
Determined by: RLF Dollars Loaned divided by Total Jobs compared to RLF Plan Target (ED-209, Line IV.E.6) *ED-209: III.A.7, RLF $ Loaned ÷ IV.E.5, Total Loans*	Less than 90% of RLF Plan target	90% to 110% of RLF Plan target	Greater than 110% of RLF Plan target

III. Responses to Comments on the Draft Measures

Performance Metric: Assets

Q1: A commenter asked whether, in evaluating the Loan Write-Off Ratio measure and the Dollars Written-Off measure, EDA planned to consider write-offs over the life of the RLF award, even where the RLF award was originally granted decades ago. The commenter noted that it is possible that an RLF award experienced significant loan write-offs early in its existence, but fewer in recent years.

A1: The Risk Analysis System is intended to assess the cumulative performance of RLF awards, including those that are decades old, and so the Loan Write-Off Ratio measure and the Dollars Written-Off measure assess write-offs over the life of the RLF award. However, there are 15 measures in total, many of which are limited to contemporaneous events, such as recent audit findings. Additionally, RLF Administrators are empowered to work with RLF Recipients and consider both historic and recent performance in determining whether corrective action is appropriate.

Performance Metric: Management

Q2: A commenter noted that the Tenure measure considers, among other things, the tenure of an RLF Recipient's Executive Director. The commenter urged EDA to consider the person directly involved in the day-to-day management of the RLF award to be the Executive Director for the purposes of the Tenure measure. According to the commenter, some RLF awards may be administered by an RLF Recipient's Finance Director, while the Executive Director may be a political appointee that changes frequently and is not involved in the day-to-day management of the RLF award.

A2: The Tenure measure assesses the experience of the key personnel that should be engaged in the administration of the RLF award. The roles critical for a successful lending program include: Executive Director, Lending Director, Finance Director, and Reporting Official. EDA believes that these personnel should be engaged in the management of the RLF award, even in large organizations or those headed by political appointees. For this reason, the Tenure measure will consider the tenure of the RLF Recipient's Executive Director together with the other three key positions.

Performance Metric: Liquidity

Q3: Several commenters asked how the Cash Percentage measure would be assessed and, in particular, how loans committed or approved, but not yet funded, would be treated under the measure.

A3: The Cash Percentage measure evaluates an RLF award's current amount of RLF Cash Available for Lending against the Allowable Cash Percentage. RLF Cash Available for Lending excludes loans that have been committed or approved, but not yet funded, including the unused balance of a line of credit. Thus loans that have been committed or approved, but not yet funded, will not count against an RLF award for purposes of the Cash Percentage measure.

Relatedly, EDA plans to determine the Allowable Cash Percentage for each EDA Region on an annual basis. The Allowable Cash Percentage will be equal to the average percentage of the RLF Capital Base maintained as RLF Cash Available for Lending by RLF Recipients in each of the six EDA Regions. As RLF Cash Available for Lending excludes loans that have been committed or approved, but not yet funded, such loans will likewise not be included in the calculation of the Allowable Cash Percentage.

Q4: One commenter requested that EDA assess the Cash Percentage measure in such a fashion that all RLF awards are measured "on a level playing field." (Note that EDA implemented the previous Capital Utilization Standard, which was eliminated pursuant to EDA's regulatory update, effective January 2, 2018, in a manner that required RLF awards with a larger RLF Capital Base to maintain a higher capital utilization rate.)

A4: The Cash Percentage measure evaluates an RLF award's current amount of RLF Cash Available for Lending against the Allowable Cash Percentage. The Allowable Cash Percentage applies to all RLF awards in a given EDA Region, without regard to the amount of RLF Capital Base. Thus the amount of an RLF award's RLF Capital Base is not a consideration in assessing the Cash Percentage measure. EDA designed it this way to provide the level playing field the commenter is requesting. See also the response to question 5.

Q5: One commenter suggested calculating an Allowable Cash Percentage for each U.S. state rather than calculating an Allowable Cash Percentage for each of the six EDA Regions.

A5: In formulating the Allowable Cash Percentage, EDA worked to identify the appropriate geographic scale from which to assess variations in economic and lending conditions across the country. While a state-by-state calculation might have been feasible for larger states that have many RLFs, it would not have been viable for states with a small number of RLF awards. For example, in states with only a single RLF award, a single-state Allowable Cash Percentage would yield a fixed score on the Cash Percentage measure, regardless of the sufficiency of that RLF award's management of capital. Calculating an Allowable Cash Percentage for each of the six EDA Regions will balance the need for a sufficient number of RLF awards to constitute a representative sample with the need to accommodate variations in economic and lending conditions across the country.

Performance Metric: Strategic Results

Q6: A commenter asked whether the Leverage Ratio measure assesses capital leveraged over the life of the RLF award or whether the measure only assesses capital leveraged by presently outstanding loans.

A6: The Risk Analysis System is intended to assess the cumulative performance of RLF awards. For this reason, the Leverage Ratio measure assesses capital leveraged over the life of the RLF award, whether stemming from loans in repayment, loans that have been fully repaid, or loans that have been written off. Note that EDA's regulations at 13 CFR § 307.15 outline the leveraged capital requirement.

Risk Analysis System Scoring

Q7: Several commenters asked how the Risk Analysis System rating for each RLF would be determined, and in particular what the range of scores would be for an A, B, or C.

A7: EDA will determine the range of scores for each rating level (A, B, or C) using the data submitted by RLF Recipients for the reporting period ending March 31, 2018 (for which reports are due by April 30, 2018).

Q8: One commenter urged EDA to consider incorporating a weighting system into the Risk Analysis System, meaning that some measures would have more importance than others in calculating the final risk rating for an RLF award. The commenter reasoned that such weighting would provide a more accurate assessment of the risk profiles of RLF awards. That same commenter also suggested that EDA evaluate the Risk Analysis System over time in order to continuously update and improve the fifteen constituent measures, and noted that such continuous program assessment and improvement is used in many oversight programs to ensure continued optimization and the ability to deliver on program objectives.

A8: EDA appreciates both suggestions. EDA plans to closely monitor and assess the Risk Analysis System, especially during the initial implementation phase, and it is possible that EDA will make small changes to the measures and eventually weigh some measures more heavily than others in calculating the risk rating. However, EDA values consistency and fairness in evaluation, and any future changes to the Risk Analysis System will be gradual and carefully considered.