Revolving Loan Funds

Ten Building Blocks for Public Charter School Facility Funds

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Public charter school facilities projects need loan capital and place-based revolving loan funds, often managed by state and local governments, are a promising solution. Prospective funds can learn from the experience of existing funds.

CHARTER SCHOOL FACILITY CENTER AT THE NATIONAL ALLIANCE FOR PUBLIC CHARTER SCHOOLS

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Case Study: DC's $1 MM Direct Loan to the Elsie Whitlow Stokes Community Freedom Public Charter School.

Linda Moore created her vision of a community-minded, language immersion public school, that would reflect her values and those of her mother and namesake for the school: Elsie Whitlow Stokes. The Stokes school was in its second temporary home, an educational wing of a church in the diverse, but gentrifying, Mount Pleasant neighborhood, which had been a long-time center of DC's Hispanic community.

After searching all around DC to find a facility that could serve as a permanent and accessible home for the Stokes school, one of its board members, a successful DC real estate professional, identified a former seminary for sale that offered promise. Located in DC's Brookland neighborhood (often referred to little Vatican given the concentration of Roman Catholic organizations), this former seminary was located at the end of a cul-de-sac that afforded relative privacy from the bustling neighborhood main street, and a sanctuary for mature trees and birds in addition to its prospective young human visitors.

The building had "strong bones", and the former seminary's floor plan was adaptable to school use: building length corridors connecting separate rooms with windows overlooking the property's ample green yards and foliage. As a bonus, the site included a full industrial quality kitchen, an amenity that the Stokes school treasured for its potential to prepare and cook healthy meals on site. While the property was located a little further east than Stokes' current home and its target neighborhoods, the property seemed to offer everything Linda Moore would want in a site, short of an actual purpose-built school building. Now she needed to conjure a plan to finance the acquisition and renovation of the property.

Compared to many of its peers in the public charter sector, Stokes was relatively healthy from a financial perspective, the result of years of strong financial practices and wise financial decisions. Stokes had accumulated cash reserves that could be used as a deposit for the purchase contract and as equity to support the acquisition and renovation project. Validation of the Stokes school's creditworthiness was provided in the form of a Term Sheet from a regional commercial real estate lender, who offered to finance approximately 80% of the Loan-to-Value (LTV) of the acquisition and renovation project, under terms which were affordable to the school over the life of the loan. Together with its cash reserves, and a $1 MM second trust (subordinate) loan from a local CDFI lender, securing a permanent home was now almost within reach. The school just needed to secure an additional $1 MM in funding. The school turned to the DC Government's State Education Office and its Revolving Direct Loan Fund to fill the final gap and close the deal.

Part 1: An Overview of DC's Revolving Direct Loan Fund for Charter School Facilities

One example of a state-level governmentally managed revolving loan fund (RLF or Fund) for charter school facilities is the District of Columbia's (DC) Office of the State Superintendent of Education's (OSSE) Direct Loan Revolving Fund for Charter School Improvement. It is among the earliest state government charter school loan funds in the United States. According to OSSE, "As of May 2021 …it had disbursed more than more $67MM to 49 public charter schools leveraging more than $492MM in additional funding for school facilities."

Origin of the Fund

DC was one of the earliest adopters of a charter school law. Its charter school law, the DC School Reform Act of 1995, was passed through Congressional action in 1996. DC's first charter schools opened in the fall of 1996. In those nascent years of the charter school sector, the DC Government provided several of the earliest charter schools with homes in closed DC Public Schools (DCPS) facilities. In 1999, the DC Council funded the 1st per-pupil charter school facilities allowance, that strengthened charter schools' capacity to negotiate for space and finance facility improvements. From 1995-2001, a Congressionally appointed Financial Control Board oversaw DC's finances. Real estate was relatively inexpensive, and DC had several former DCPS properties in its inventory[1]. Between 1998 and 2001, the DC Control Board released several of these surplus and empty facilities to charter schools and to developers for economic development purposes. By 2002, as the number of surplus closed DCPS facilities dwindled, charter schools were compelled to search for commercial market sites which required access to debt financing to acquire and finance the renovation of school facilities. This presented a new challenge for this emerging sector and a new unexplored market niche for local commercial lenders.

In FY2001, DC established one of the earliest Credit Enhancement Funds in the nation. DC housed the Credit Enhancement grant program within the Department of Banking and Financial Institutions, with an independent all-volunteer committee that reviewed and approved transactions financed through the Fund. Between 2001-2003, this Fund supported at least five (5) charter schools with the acquisition and renovation of both former DCPS and commercial properties. The Credit Enhancement Fund provided recoverable cash grants to schools who used the cash as collateral in securing "senior" bank financing. Some of these transactions were structured as two separate senior loans: one secured by the credit enhancement cash collateral and the other secured by the real estate collateral. While this structure assisted

[1] DC operated a segregated system of public schools until 1954. Together with a decline in the population of school-aged children, had a plethora of unused and empty school facilities.

charter schools in securing financing, it also resulted in low credit enhancement leverage ratios, without any reduction in the market interest rates.

The Need for a Revolving Loan Fund

Commercial real estate transactions that are credit enhanced can pose challenges for charter schools: high market interest rates, higher required debt service coverage ratios, and limited capital accessible for tenant improvement loans. To help overcome these challenges, DC created a Direct Loan Fund. The U.S. Congress established and funded DC's Direct Loan Fund in 2003 through a direct appropriation (Federal Payment) of $5 MM[2]. Passed in Fiscal Year (FY) 2003, Public Law 108-7 states: "There is established within the District of Columbia a Direct Loan for Direct Loan Fund for Charter School Improvement…Funds distributed under this subsection shall be for construction, purchase, renovation, and maintenance of charter school facilities."

Charter School Real Estate Lending Basics:
Some key terms related to Revolving Loan Funds:

- Sources and Uses of Funds
- Loan to Value (LTV) ratio, Loan to Cost (LTC) ratio
- EBITDA
- Debt Service Coverage Ratio (DSCR)
- Cash Forecast, pro forma
- Collateral, Security Interest, Assignment
- Senior v. Subordinate Debt
- Loan Covenants
- Amortization Period

The purpose of the Direct Loan fund was to provide both first trust and subordinate loans. Since a commercial lender will typically only finance a percentage of the completed value of a charter school facility project, there will be a funding gap that charter schools need to fill with additional debt or equity. The gap represents the difference between the level of financing a bank is willing to provide and the total costs of the real estate project. To calculate their maximum financing offer, banks use metrics such as Loan-to-Value (LTV), and Debt Service Coverage Ratios (DSCRs). In 2004, typical LTV ratios ranged between 75-80% of the charter school's completed project's appraised value. Depending on the cost of the project compared to the appraised value, a charter school would typically have to supply 20-25% of a project's costs in the form of cash equity or additional debt. DC's Revolving Loan Fund was formed and designed in part to help fill this gap, by offering short to medium term loans with favorable

[2] Public Law 108-7--February 20, 2003, 117 STAT 131. Embodied in DC Official Code §§ 38-1833.01 and 38-1833.02.

terms. Favorable terms can take the form of below-market interest rates, interest-only repayment periods, or long (i.e. 30 year) amortization periods to calculate principal and interest payments. To finance the repayment of the direct loan, schools rely on increases in enrollment (and hence cash flows), build relationships with donors, and prepare for long-term fixed-rate refinancing (ex. Tax-Exempt Revenue Bonds) to take out the direct loan.

Some Shortcomings of Credit Enhancement

Why not rely on credit enhancement to increase the level of bank financing rather than rely on a direct loan fund? There are a few reasons why a direct loan fund may be the only viable, or at least the most practical and economical, option compared to a credit enhancement.

First, while credit enhancements may induce a lender to increase its loan amount due to the additional collateral, the additional loan amount will typically carry the same interest rate as the rest of the senior debt. This can result in tens of thousands of dollars of additional interest expense and cash outflows for a non-profit school.

Second, for some riskier transactions such as leasehold improvements with limited collateral, there may be no bank willing to lend into the transaction. This is an example of where a state-level revolving loan fund for charter school facilities fills an unmet need.

Finally, the charter school sector has experienced transactions in which the banks accept the credit enhancement, yet do not increase the LTV. Private commercial banks' business model is based on mitigating and leveraging risk. Once a bank is aware of the credit enhancement, the bank may simply rely on, and depend on, the credit enhancement to alleviate risk exposure in the transaction and their overall loan portfolio. A bank might not pass on the benefits of the credit enhancement to the school borrower. Savvy and experienced financial advisers can negotiate to increase the leverage of the credit enhancement, but this can be challenging in an immature charter school lending market.

While these are some of its shortcomings, a credit enhancement fund can still be valuable. Some specific uses include guaranteeing leases for new schools; guaranteeing payments for charter schools during their early enrollment and "ramp-up" periods; funding debt service reserves; or providing financial security during pre-planned facility vacancy periods due to tenant transitions and renovation periods.

Early Implementation of DC's Revolving Loan Fund (2003-2007):

The early years of DC's RLF were challenging. Launched initially within the DC Department of Banking and Financial Institutions, the Fund relied on outside contractors and invested its cash into dubious investments. By 2005, the Mayor ordered the transfer of the Fund to the State Education Office. Turnover among staff and the Credit Committee hindered its ability to execute transactions and meet its potential for serving the sector. From a market perspective, by 2006 there were fewer surplus DCPS facilities available and the locally-elected school board (prior to the Mayoral takeover of DCPS that resulted in the appointment of Michelle Rhee as Chancellor) was maintaining a portfolio of under-utilized facilities with few new or modernized facilities. Despite declining enrollment in DCPS neighborhood schools, few facilities were opened for charter schools. Charter schools were compelled to tap the more expensive commercial real estate market for space.

By early 2007, the State Education Office hired its third Director in four years and would build the foundation for increased impact and innovation in facilities financing for the growing charter school sector[3]. Some of those initial building blocks included creating standardized templates for credit underwriting; standardizing the process for Credit Committee meetings and approvals; developing a financial reporting and management system; and establishing templates for the legal documents. The Mayoral takeover of the schools later that year would present both new challenges and new opportunities.

In the Spring of 2007, the DC Council passed legislation to dissolve the local DC Board of Education and delegate oversight of DCPS to the Mayor. This legislation also eliminated the DC Board of Education's Charter Schools Office (the local board was initially one of two active authorizers in DC, together with the DC Public Charter School Board (PCSB)), transitioning over a dozen charter schools to the PCSB's oversight. By the spring of 2008, Chancellor Michelle Rhee had identified 23 DCPS schools for closure due to low enrollment. These policy decisions had a few implications for charter schools in DC: 1) several former DCPS facilities would become available for lease to charter schools; and 2) several of the poorly monitored charter schools would be scrutinized by their new authorizer, the DC Public Charter School Board. The increased rigor of oversight resulted in several charter school closures, which freed up facilities—including several former DCPS facilities occupied by those DC Board of Education chartered schools—across the DC charter school sector.

[3] For school year 2006/2007, audited enrollment in DC charter schools totaled 19,662 students, representing 27% of all DC students enrolled in public schools. Source: DC OSSE PUBLIC SCHOOLS ENROLLMENT CENSUS, OCTOBER 5, 2006. Link: https://osse.dc.gov/sites/default/files/dc/sites/osse/publication/attachments/2006%20DCPS_and_PCS_REPORT_2006_FINAL.pdf

Lesson Learned: Establishing and operating a fund within a state or local agency subjects the fund to ongoing change due to leadership transitions between administrations; turnover, qualifications, and commitment of staff assigned to the fund; and the constraints imposed by shifting governmental agendas and system limitations. While there are examples of public sector RLFs for both charter school facilities and other uses, they are typically more difficult to launch within a government entity than within the private sector. That said, there are benefits of the state and local government context: potential stability and supports that can be tapped from across the government (e.g., legal support and established financial systems); a focused, "place-based" mission; public accountability and well-honed systems of internal control; and synergies with other governmental programs (e.g., community and economic development programs). While a privately managed fund may have more flexibility and an entrepreneurial culture, funders may pressure a fund to start making loans rapidly before establishing the appropriate internal control infrastructure. An effective and credible place-based revolving loan fund requires appropriate internal control systems and processes that take time and effort to establish and maintain. This may test the patience of any entrepreneurial manager or investor.

Adapting and Building the Credibility of DC's Direct Loan Fund (2008-2013)

Beginning in 2007, the RLF began to establish and document its practices. It created formalized Credit Committee policies, procedures, and practices. It added staff, including full-time and contractual staff dedicated to credit underwriting, legal support, and loan servicing. The Fund formulated GAAP-compliant internal financial statements to aid management and the Credit Committee in evaluating the Fund's performance and financial status.

The closure of DCPS neighborhood schools resulted in the disposition of these public facilities to charter schools. As a result, public charter schools needed loan capital to finance the renovation. Given that DC charter schools rented but did not own these facilities, securing commercial bank financing was an initial challenge given the lack of collateral to secure the bank's loans. The global financial crisis in 2009 presented additional challenges for charter schools seeking to finance facility projects. During this crisis, banks were more conservative in their underwriting; for example, LTV ratios often declined below 70%, versus the range of 75-80% seen prior to the crisis.

These two contextual factors—charter schools' increased demand for leasehold improvement loans and more rigorous credit underwriting standards by local banks—meant that charter schools would rely on OSSE's programs and its RLF even more.

Lesson learned: The initial volume of transactions within a RLF may not be sufficient to hire multiple full-time staff members with a range of experiences. Ideally, the Fund manager is also responsible for other activities, spreading the manager's time and effort across multiple resources (e.g., the Federal Charter Schools Program State Entity grant). As noted earlier, an effective RLF requires a lot of reporting, and it is not something that can be managed by part-time staff.

Recent Experiences in a Tight Market (2014-2019)

After six years of regular building dispositions to charters, by 2014 there were few former DCPS facilities available to be leased to charter schools. As a result, charter schools faced the position from the early 2000's: securing real property in an increasingly expensive commercial real estate market with an insufficient per pupil facilities allowance. The DC charter school facilities allowance increased by only 7% since 2008. In this current context, the RLF becomes a critical gap filler for transactions desperate for loan capital or tenant improvement loans for commercial sites.

Part 1: Summary/Takeaways from DC OSSE's Experiences with its RLF

1. A Credit Enhancement product can be very valuable, but not sufficient.

2. Market conditions dictate the need for different financial products. Increasing land and construction costs, or leasehold improvements with less collateral, created the need for a subordinate debt fund.

3. Starting a RLF in a government agency without the benefit of other examples can be challenging.

Part 2: ***The Ten Essential Building Blocks for a Credible Revolving Loan Fund***

Managing a Revolving Direct Loan is a challenging enough task in the private and non-profit sectors. As OSSE learned, creating one within a state or city governmental agency is arguably even more difficult, but the payoff for residents and program beneficiaries can be huge: a dedicated, place-based fund with a sole purpose of assisting the state's or city's high-quality charter schools to secure and finance new and expanded facilities.

This paper identifies ten (10) building blocks for launching and sustaining an effective and credible loan fund within the public sector. These basic elements are explored in detail below.

These are 10 Building Blocks for a Credible and Effective Charter School Facilities Loan Fund:

1. Loan Origination: Public Outreach and Marketing
2. Loan Policy: Lending Criteria, Standards, and Loan Terms
3. Credit Rating Methodology: Standardized Loan Underwriting Process
4. Loan Approval: Competent and Transparent Credit Committee Representing a Range of Perspectives
5. School Quality: Open Flow of Communication with Charter School Authorizers
6. Loan Administration: Servicing, Compliance, and Performance Monitoring
7. Annual Loan Portfolio Risk Assessment
8. Cash Management: Systems and Policies
9. Financial Management: Reporting Systems
10. Staffing: Resources to Maintain a Competent Full-Time Staff and Other Administrative Expenditures

Building Block #1. Loan Origination: Public Outreach and Marketing

After funding and setting up an RLF, an organization will need to conduct outreach and marketing across different sectors, including charter schools, charter support organizations, charter school authorizing entities, CDFIs, other prospective senior and sub-lenders, and charter school finance specialists. Among other things, these actors will need comprehensive and timely information about the availability of funding, the application process, lending criteria and terms, and Fund performance and activities. This public outreach and marketing effort should also communicate the Fund's "why": *Why is the Fund being created? Why do public charter schools need access to new sources of loan capital?*

Lesson Learned: A RLF needs a marketing agent, for schools and other lenders. This is often not a common role for government agencies.

Building Block #2. Loan Policy: Lending Criteria, Standards, and Loan Terms

Among the first policy decisions a new RLF for charter schools will need to make is around is defining it's "what." This includes the types of transactions and the criteria the RLF will follow to make investments. This is often spelled out in a Loan Policy Manual. Examples of these minimum criteria include the following: the *maximum loan size*; loan terms, including *interest rate policy* and *amortization rates*; and underwriting standards, such as *maximum total loan-to-value ratio*, *debt service coverage* requirements, and other special covenants, such as *minimum cash on hand*. For OSSE, both the initial legislation and its ongoing policy has been to limit direct loans to $2 MM per facility transaction. Given that DC charter schools' facility projects costs have typically totaled in the range of $3-30 MM or higher, a maximum loan of $2 MM keeps OSSE's RLF within the range of gap financing, rather than serving as a primary lender. Through this role, the Fund has often compelled schools seeking additional subordinate debt to cultivate relationships with other not-for-profit lenders (e.g., Commnuity Development Financial Institutions (CDFIs)) who can share the risk and strengthen the transaction through their own due diligence. For example, several transactions have included Building Hope, a DC-based CDFI, as a co-lender with loans of similar size and terms.

OSSE adopted an informal policy of limiting the total transaction LTV at 100%. However, as the fund began lending into leasehold projects – for example, closed public school facilities leased by the DC Government to charter schools – that target was modified to a ratio of 100% of *loan to cost*.

For debt service coverage, OSSE has generally required that the total *debt service coverage ratio* be at least 1.0 based on the per pupil facility allowance. In the past, OSSE encouraged schools to demonstrate they could pay for their facilities with the District facilities allowance which is relatively larger than those other states that also have a facilities allowance. This helped to discourage transactions that required schools to dip into revenue dedicated to instruction and other non-facilities expenditures. Unfortunately, given rising real estate costs that outpace the increase in the facilities allowance, this is not always feasible. Other states with smaller facilities allowances would find it a challenge to limit the debt payments to the facilities allowance.

OSSE RLF loan terms are typically limited to five years. By the end of five years, charter schools are expected to have 1) increased cash flows through expanded enrollment; 2) executed an aggressive capital campaign; and/or 3) prepared themselves for takeout financing through a conventional commercial bank loan or tax-exempt bond financing. That said, in some cases OSSE may seek a shorter term to expedite repayment and to facilitate more rapid revolving of funds; in limited cases, OSSE extended the loan term to seven (7) years to coincide with the term of New Market Tax Credit transactions.

Lesson Learned: Be transparent about the Fund's loan terms. Do not try to build a RLF policy from scratch. Find ways to partner with other RLFs and experts who have done this or are doing similar work and gain an understanding of their loan terms and underwriting practices.

Building Block #3. Credit Rating Methodology: Standardized Loan Underwriting Process

As is the case with any industry, charter schools are a unique business model with characteristics that must be considered while underwriting their credit. Similar to the oversight of schools generally, there are basic elements for underwriting a charter school transaction: understanding a school's academic program and performance; assessing a school's financial capacity, and the merits of the proposed financing transaction; and evaluating the quality and rigor of school governance. For a state or local revolving loan fund that is underwriting a charter transaction, a standard due diligence process should address the following three elements, and associated key questions:

- Charter School Academic Program and Performance:
  - *What are the academic goals in the school's charter, and what are the minimum criteria for charter renewal?*
  - *How is the school rated under both the state and authorizer accountability systems?*
  - *Does the charter school provide a program that is in high-demand, ensuring a sustained level of per-pupil revenue?*
  - *For high schools, what is the graduation rate, the college enrollment rate, and the college completion rate?*
  - *What can be gleaned from the charter school's authorizer and SEA monitoring and review reports?*
- Financial Performance and Transaction Specifics
  - *What are the charter school's annual financial performance goals, and what are the minimum criteria established by the charter school authorizer?*
  - *What are the anticipated cash flows for the school for each of the next five years?*
  - *What is the school's debt service coverage ratio (EBITDA/ [Debt Principal + and Interest Payments]) over the term of this loan?*
  - *What are the sources and uses of funds, and the Loan-to-Value ratio? Is the project budget reasonable? Has the school performed the appropriate due diligence on the project site (e.g., test fit, environmental assessments, zoning analysis)?*

- Governance Rigor:
    - *Do the nonprofit charter school's governing board of trustees meet the state's and authorizer's requirements for size, meeting minutes, and transparency?*
    - *Do the trustees represent a range of experiences, including finance and business law?*
    - *Do the school's board of trustees hold the school leader accountable for high academic and organizational expectations?*

In addition to the specifics of the deal in question, a state level RLF should also address the broader local context of public education and charter schools as part of its underwriting. For example, an RLF should assess the level of financial support provided to charter schools through state and local budgets and the likelihood that support will continue and increase into the future.

The underwriting elements cited above will enable an RLF to assess the following types of risks impacting the proposed credit transaction: *credit risk; charter risk; enrollment risk; organizational risk; environmental and political risk*.

> **Lesson Learned:** There are many lenders that have developed thorough underwriting policies and procedures for the charter school sector. To avoid starting from scratch, connect with existing CDFIs and the National Alliance's Facility Center to build out these processes.

Building Block #4. Loan Approval: Competent and Transparent Credit Committee Representing a Range of Perspectives

Nearly all lenders in the private, non-profit, and public sectors have credit committees which make the final decisions on loans. A credit committee provides objective, impartial, independent, and expert insight to guide decision-making around the investment of loan funds into a charter school real estate transaction. A credit committee should include experts who bring specialized experience from the domains of real estate finance, education policy, charter schools, commercial lending, and business law. In addition to domain expertise and independent thinking, credit committee members should have an understanding and awareness of the local context of charter schools and real estate development.

A unique aspect of an RLF housed within a state or local government agency is the need for transparency and public accountability around the loan approval process. To meet these requirements and expectations, a public RLF should notify the public about its Credit Committee meeting schedule and provide timely and accurate agendas and minutes of public meetings. Members of the Credit Committee should disclose any potential conflicts of interest related to transactions under their review. The criteria for approving loans and the terms of each loan should be clear and available to members of the public.

Lesson learned: Finding financially and charter school savvy professionals who can dedicate significant time to a credit committee and who will not be conflicted out of transactions is challenging. Managing the governance of a credit committee, including public notifications of its meeting schedule and meeting minutes can require a substantial investment of time each month. Borrowers will inevitably have concerns over the credit committee's decision-making and the final terms of the loan. Foundations are aware that there is backlash any time they deny a grant request. This same phenomenon can happen to a loan fund. Prepare for it through transparency around the decision-making process.

Building Block #5. School Quality: Open Flow of Communication with Charter Authorizers

The authorizer is an essential partner during both the underwriting and post-close loan servicing and monitoring process. During the credit underwriting process, RLFs must consult with authorizers and review all available reports from authorizer reviews and assessments. This practice will ensure that an RLF is reviewing all publicly available information pertaining to a charter school's performance and viability. During the loan servicing and monitoring process, charter school authorizers can help to ensure the integrity of the loan, as a charter school's failure to demonstrate the ability to repay the loan calls into question the rigor of financial management and governance. Finally, an RLF and a charter school authorizer should communicate about their financial reporting processes in order to calibrate reporting, minimize burden on the charter school borrower, and help identify meaningful measures and metrics for evaluating a charter schools' financial health.

An excellent resource on the topic of collaboration between charter school authorizers and RLFs is a publication by NACSA: Lenders and Authorizers, Can We Talk?, (2013).

Lesson learned: It is important for the RLF to maintain frequent and transparent communication with the charter school authorizer. By keeping open the lines of communication, the RLF can reduce reporting burdens and gain deeper insight into the financial health of the school.

Building Block #6. Loan Administration: Loan Servicing, Compliance, and Performance Monitoring

In addition to implementing the business processes related to loan underwriting, an RLF must establish an efficient and thorough system for servicing the loans in its portfolio. Included within the loan servicing function are the processes for calculating and tracking borrowers' payments of principal and interest; loan covenants and reporting; and a system for evaluating and assigning risk ratings for each loan it its portfolio.

An RLF may elect to track these elements through a customized spreadsheet and other ad hoc or free tools. However, there are several inexpensive yet powerful software tools that an RLF can procure to automatize and maintain its loan servicing and compliance tracking. For example, DC OSSE's RLF adopted a system called "PORTFOL" (see link here). PORTFOL is a portfolio management system that includes loan servicing, tracking of technical assistance and monitoring activities, and can track other elements of an RLF portfolio.

Building Block #7. Annual Loan Portfolio Risk Assessment

A state-level RLF should establish its risk tolerance and manage that risk through an annual portfolio risk review and aim for a portfolio balanced by high to low risk investments. For example, in 2009 the Program Manager over the OSSE RLF established an annual loan portfolio risk review process. This process included both objective and subjective ratings in the areas of finance, academic quality, governance, and overall risk. OSSE shared this portfolio review with its RLF Credit Committee. OSSE also used the outcomes of this review to inform the annual monitoring and technical assistance plan.

An RLF should consider establishing target caps on the volume of high and medium risk loans that comprise the portfolio. For example, start-up charter schools typically are the highest-risk loans, given that new charter schools have no enrollment track record, academic results, or accumulated net assets. To mitigate the risk these types of loans introduce to the portfolio, an RLF may consider establishing limits on the size of loans to new schools at both the individual loan and aggregate fund levels.

Lesson learned: Level set stakeholder's expectations about losses. If a loan fund has no losses, it really hasn't taken on any risk and arguably hasn't really tackled the problem it was created to solve. Decide if a 25%, 10%, or 3% loss rate is acceptable. Be transparent about that projected loss rate and account for it within the RLF's financial records as a loss reserve.

Building Block #8: Cash Management System and Policies

Cash management—related to both the management of "idle" net assets available for lending, as well as cash inflows from repayments—represents a critical business process, and an area susceptible to internal control risk. At the onset of establishing a Revolving Loan Fund, cash balances will be high as the fund launches its business practices, sources new investments, and underwrites the initial transactions. Most states and localities have Treasury laws or regulations regarding eligible methods for investing cash. Cash for an RLF needs to be liquid but can generate a nominal return through investment in a savings, money market, or CDARS account.

Lesson learned: Idle cash is always of interest to other competing demands in government. Make sure it is restricted to the Fund and invested strategically to minimize risk while still offering a nominal return.

For repayments of loan principal and interest, RLFs should avoid collecting paper checks and establish an electronic payment process. Best practices for sound internal controls suggest that the cash account for collections should be separate from the account for idle, available cash. After an RLF reconciles and records repayments in its loan servicing records, it can initiate transfers out of the collection account and into the primary cash account.

Building Block #9: Financial Management and Reporting System

A typical state or local government budget and finance professional is typically focused on one primary objective: oversight of a public agency's budget and ensuring that encumbrances and expenditures comply with appropriations law and funder requirements.

An RLF presents additional challenges for a public agency's staff, including its financial managers. First, an RLF requires a *balance sheet focus*, which is typically the domain of government accountants, and not program finance staff. An RLF's assets are comprised of assets in the form of cash available for new loans, and loans receivable. The sum of these assets, less any outstanding liabilities, equals the fund's *total fund balance*, or *net assets*. Given the revolving nature of the fund, the resources available for programmatic use are derived from the uncommitted fund balance (e.g. *total fund balance* less *loans receivable*). An RLF formulates its annual budget based on an estimate of uncommitted fund balance available to the program at the beginning of the year. As loan principal payments are received and interest revenue is collected, an RLF may need to modify the original budget to reflect newly available resources for program activity. This approach toward public program budgeting is unlike the typical approach for a governmental entity's General Fund.

If a governmental RLF tracks its income statement activity within governmental budget accounts, then there are specific accounting journal entries related to loans, dictated by both regular and governmental GAAP. As loans are disbursed, a program expenditure is recorded against a budget for the full amount of the loan. Simultaneously, the RLF records the loan receivable, and a credit against a general ledger expense account that can be titled "*GAAP not Budget Expenditure*". This reflects the reality that a loan disbursement is not an outflow of net assets, but merely a conversion of net assets, as cash assets fund a new loan receivable.

Similarly, as a RLF receives loan principal repayments, an RLF must record one journal entry to receive the cash and record loan principal repayment proceeds; simultaneously, the RLF reduces the receivable and debits a general ledger revenue account typically titled, "*GAAP not Budget Revenue*".

In addition to these RLF specific journal entries, an RLF must maintain either separate general journal accounts or a subledger to track each individual loan receivable. RLF financial management staff should reconcile the balances in a RLF's general ledger to individual loan amortization tables (or the loan serving sub-system) on at least a quarterly basis.

An example of state government memo that describes the accounting treatment for RLFs is here.

> **Lesson learned:** The reporting systems for an RLF are complex and are often different than standard government reporting systems. RLF managers must establish the accounting infrastructure and reporting formats at inception to ensure efficient, timely, and compliant financial oversight.

Building Block #10: Resources to Maintain a Competent Full-Time Staff and Other Administrative Expenditures

Depending on the size of an RLF and its volume of transactions, an RLF needs the following basic functions to be delegated to staff:

- Fund Leadership
- Credit Underwriting
- Loan Servicing
- Financial Management
- Legal Support and Documentation

To ensure staffing adequacy and continuity, an RLF should determine the minimum annual costs to manage the fund, and the source of those resources. For example, the legislation establishing DC OSSE's RLF permits the Fund to allocate up to 5% of its uncommitted fund balance to administrative expenditures, including personnel costs. As a Fund disburses loans, uncommitted net assets decrease, thereby decreasing resources available for administrative expenditures. At inception, an RLF should consider how it will cover its administrative expenditures so that it avoids resource shortfalls later in the Fund's lifetime.

> **Lesson learned:** There needs to be consistency in the staffing of an RLF. It is likely that the staff positions will be subjected to high turnover. The fund may need to be managed by an entity that is offering other services so there can be consistency and stability in staffing.

RLFs, School Quality, and Results

In addition to the 10 Building Blocks, there are two more considerations on how RLFs can exert influence over the quality of charter schools within its service area, and the importance of ongoing measurement and reporting of Fund performance.

Influence over Charter School Quality

A state and local public sector RLF can exert influence over the quality of the charter schools within its geographic area of focus. Whether a charter school has an appropriate and affordable facility is one of the most important factors contributing to a charter school's success, failure, and sustainability. An RLF will have influence over which schools are able to open, expand, or remain open. For better or worse, in this way an RLF can act as a de facto charter school authorizer. In addition, an RLF, through its loan covenants, may apply pressure on charter schools performing poorly on financial measures. This pressure may result in the early closure of some poor performing schools.

An RLF also can exert leverage over the financial governance and operations of a public charter school, which can be a powerful opportunity to encourage sound financial management practices and oversight. This leverage can be applied through the underwriting process, loan covenants, loan servicing and compliance requirements, and the loan monitoring process.

During the credit underwriting process, an RLF can establish ambitious criteria for loan approval, thereby encouraging the highest quality schools with sound financial transactions to apply for support. Loan covenants can require levels of cash-on-hand and the maintenance of dedicated reserve and repayment accounts. Through the loan servicing process, an RLF can establish cash management and other financial management practices that promote fiscal discipline and fiscal oversight. For example, an RLF can require the assignment and segregation of various cash revenue streams, and regular reporting of financial status. All of these practices help to establish strong internal controls within a charter school and its board of trustees.

Through ongoing and open communication and collaboration with charter school authorizers, an RLF can help create high expectations for fiscal performance, minimize duplicative reporting and monitoring by the authorizer and RLF, and leverage the authorizer's oversight powers to ensure the integrity and repayment of the RLF's loans receivable. An RLF can complement a charter authorizers' oversight, given the RLF's authority to impose covenants and compliance requirements in the areas of governance, academic results, and operations--including within the areas that fall beyond the authority of the authorizer itself.

Measuring Impact and Return on Investment

A good practice for RLFs is to compile data and information about the results of the funds' loans. Funders, which may include philanthropic and corporate foundations, and federal, state, and local governments and taxpayers, need regular and relevant measures of the fund's impact and return on investment. Examples of measures which should be collected about schools supported by the RLF include the number of loans disbursed annually and from inception-to-date; the Fund's annual and cumulative default and loss rate; the number of gross square feet developed; and school performance metrics. Academic data about the schools, such as annual academic performance, high school graduation rates, college acceptance and enrollment rates, and authorizer ratings, help funders and the public to evaluate the value of the fund.

Part 2: Summary/Takeaways from the 10 Building Blocks for a Place-Based Charter School Facilities RLF:

1. Proactive loan sourcing is a new skill set for government agencies.
2. Partner with existing lending agencies when developing loan policies.
3. Be clear about the risk profile of the loan fund.
4. Identify talent to manage the Fund and to approve loans.
5. Financial reporting for lending is different in government agencies.

Conclusion

Given the complexity and challenges of financing charter school facility projects, state and local (place-based) revolving loan funds offer a promising solution to addressing charter schools' needs for financing. Whether used as gap financing/subordinate debt or as the primary source of loan capital, RLF loans provide essential capital for charter school facility projects. State and local actors should consider RLFs among their arsenal of strategies to solve the charter school facilities challenge. Like DC OSSE's Direct Loan Fund, there are examples nationally of state and local governments, non-profit lenders, and other entities who have launched successful and impactful loan funds. The ten (10) practices identified in this paper will help new funds to experience success and avoid pitfalls. As more information and experiences are identified and shared, we believe that a community of practice will emerge among place-based funds that will exchange information and practices to scale the impact of this innovative charter school financing solution.

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