CDBG Program Eligibility of Collateral Reserve Accounts

October 1, 1988

MEMORANDUM FOR: James T. Chaplin, Office Manager,
Jacksonville Office, 4.6S

ATTENTION: Cleveland B. Talmadge, Director for Community Planning and Development, 4.CC

FROM:Jack R. Stokvis, Assistant Secretary for Community Planning and Development, C

SUBJECT: Community Development Block Grant (CDBG) Program Eligibility of Collateral Reserve Accounts City of Jacksonville, FL

This is in response to a request by your staff for a review of an economic development program which was designed, adopted and used by the City of Jacksonville in the implementation of the Jacksonville Business Improvement Loan-Collateral Reserve Program, (JBIL-CR). The purpose of the review was to determine if the program violates any financial, programmatic or other uniform administrative rules which may be applicable to such programs. From this review we have reached the following conclusions.

We have determined that the JBIL-CR program, by design, violates certain HUD and Treasury Department regulations. Based on our review of the program's policies and procedures that were supplied by your Office and in discussions with the City, we have concluded that there are three primary areas of the program that are in variance with established Departmental policy.

First, we do not believe the City has made a case to support their position that the financial institutions that serve the Jacksonville area will not participate in the JBIL-CR Program without having funds on deposit to collateralize outstanding loans. Secondly, it appears that the City has violated letter of credit drawdown rules by depositing funds in collateral reserve accounts that clearly exceed the amounts that can reasonably be expected to be needed to cover actual defaults. Third, it appears that the City has violated certain wage and labor standards under the Davis-Bacon Act. In consideration of these apparent violations, it is recommended that all current expenditures and future obligations under this program be suspended pending corrective actions to comply with applicable laws and regulations.

With respect with the first issue, drawing funds from a letter of credit before such funds are needed to cover actual default must be supported by adequate justification to demonstrate that no financial institutions will participate in the program and accept a payment guarantee without having funds on deposit. This is the first step in determining if the establishment of a collateral reserve account is an appropriate mechanism to guarantee such loans. The City has indicated that the four banks presently participating in the JBIL-CR have been contacted and have shown an unwillingness to continue their participation in the JBIL-CR program should the city discontinue the 100 percent collateral deposits. However, there is nothing to demonstrate that no other financial institutions in the area will participate and assist in the implementation of the program without a collateral reserve being on deposit. Only after a

determination has been made that no financial institutions will participate in the program based only on a guarantee should the Department accept the justification for drawing funds from a letter of in advance of default.

Even if it can be concluded that a drawdown in advance of default is justified, the amount deposited into a collateral reserve account must be reasonable. This is the next step in the process of analyzing such accounts for determining the minimum amount necessary to cover anticipated defaults. During the beginning stages of implementing a collateral reserve program, because the grantee and the banks may not have experience with such loans, it is necessary to make estimates of anticipated defaults for purposes of determining the amount of reserve required to be maintained in the collateral reserve account. However, we believe that a program policy developed that expects a 100 percent default rate is clearly unreasonable. As experience with such loans is gained an adjustment should be made to reflect actual loss experience. An appropriate index for establishing the amount of funds deposited in a collateral reserve account would be the ratio of expected losses to all loans outstanding (e.g., if expected losses have been projected to be 30 percent, the loss reserve should not exceed 10 percent of the loan principal).

According to the information submitted by the City, this program has been in effect for over seven years and the participating lenders have not experienced any losses for the 23 loans which total over $1,140,372. Based on this experience, there does not appear to be justification for deposit of any funds, unless the City has good reason to believe that defaults will occur in the future.

Based on this analysis, we believe the grantee is in violation of the Treasury rules governing cash advances at 31 CFR 205.4. This provision requires that cash advances to a grantee be limited to the minimum amounts needed and timed with the actual and immediate cash requirements of the grantee in carrying out the purposes of the approved program or project. Such cash advances are to be timed as close as administratively feasible to the actual disbursements by the-grantee for direct program costs. The direct program cost for a collateral reserve account program would be the costs incurred as a result of a loan default. We do not believe that drawdowns in advance of default, rather than as defaults occur, can routinely be considered to comply with this requirement.

The third area of concern is that the program appears to have violated the special conditions contained in the August 26, 1983 letter to Mayor Jake Godbold. The City mistakenly believes that this letter constituted approval of their program as it was structured, however, this was not the case. The sole purpose of the letter was to provide the City with a waiver to the application of 24 CFR 570.605 (Labor Standards) as then in effect to the JBIL-CR program. The waiver was subject to the following two conditions which stated that:

1. "The CDBG funds will receive at least the usual and customary interest that would accrue to demand accounts in the local area, and
2. Other terms and conditions will be similar to the usual and customary terms for collateral accounts in the area."

The interest rate paid by these financial institutions on certificates of deposit purchased by the City for the principal amount of the loan at the time of closing is set at 1.25 percent, less than the 'usual and customary' interest paid on such accounts, with the 1.25 percent being retained by the lender as a loan

fee for the life of the loan. This does not comply with the first condition of the waiver. As a result, the lower interest rate would appear to render the activity one which constitutes "financing" the activity. (An OGC opinion of April 8, 1983, concluded that the use of a CDBG collateral account which receives less than the usual interest rate accruing to demand accounts constitutes 'financing' of construction work and therefore triggers section 110 of the Act.) Even if this obstacle could be overcome, the City's program suffers from another problem that would make Davis-Bacon apply in that CDBG funds are, in effect, being used to pay the bank's administrative costs for servicing the loans. Any administrative costs paid for with CDBG funds (including program income generated from CDBG-funded activities) constitute "financing" under section 110 of the Housing and Community Development Act of 1974, (the Act), (OGC opinion of March 9, 1983, attached). We have concluded that the JBIL-CR program does constitute financing of construction work with CDBG funds and triggers Davis-Bacon applicability under Title I. This conclusion is based on the design of the program with respect to the arrangement with the banks in which collateral reserve accounts received less than the usual and customary interest and the fact that certain bank fees were paid with CDBG funds (through foregone interest).

In order to remedy violations to the letter of credit rules and to Section 110 of the Act, we propose the following corrective actions:

1. Advise the City to discontinue guaranteeing loans under this program.
2. The City should initiate negotiations with area lending institutions to determine if loans could be guaranteed (e.g., through an irrevocable letter of credit) without the need to deposit funds in a collateral reserve account.
3. In the event it is concluded that funds must be deposited in advance of default, the City should establish a reasonable loss reserve amount for each loan. The level of funds maintained in a collateral reserve account should take previous experience into consideration as a basis for determining loss reserve amounts. The loss reserve amount and the methodology for determining such amount should be reviewed by the HUD Office prior to drawdown of funds from the letter of credit.
4. All funds currently on deposit in excess of this loss reserve amount should be returned to the City's letter of credit. However, a review should be conducted of the agreements between the City and each financial institution to determine if the return of funds would constitute a breach of contract.
5. The City must determine the amount of funds previously and currently on deposit that exceeded an amount determined by BUD and the City to constitute that which could reasonably have been expected to be needed to cover defaults. Interest earned on deposit amounts so determined to have been in excess must be returned to the Federal Government in accordance with 24 CFR 570.500(a). Any interest earned on collateral accounts determined to be not in excess of required reserves would be considered as program income and should be used prior to the drawdown of additional amounts from the City's letter of credit.
6. The JBIL-CR program policies and procedures must be modified to require the City to ensure that any collateral reserve accounts bear at least the normal, usual and customary interest rates that would accrue to similar accounts for the area (in this case, certificates of deposit) or ensure that Labor Standards requirements are met by loan recipients.
7. If the City wishes to ensure that future loans do not trigger Davis-Bacon, they must avoid the use of CDBG to pay for the bank's fees for administering the loans.

The City should be reminded that funds may be drawn from its letter of credit in a lump sum to undertake eligible rehabilitation activities in accordance with 24 CFR 570.513. The City should consider the new regulations at Subpart J regarding lump sum drawdowns that will become effective on October 1, 1988, in the design of any lump sum agreements in the event they wish to pursue this option.

After you have concluded a resolution of this issue with the City, please report results to the Entitlement Cities Division. Please also establish a review process to ensure that funds required to be returned to the City's letter of credit, or to HUD, as appropriate, are transmitted in a timely manner.

Should you have any questions or concerns relative to this issue please contact Dan Dodrill in the Entitlement Cities Division at (FTS) 755-5977.

Attachment