DISTRICT OF COLUMBIA
OFFICE OF THE STATE SUPERINTENDENT OF
EDUCATION

MEMORANDUM

To: District of Columbia Public Charter Schools and Related Entities

From: Ronda Kardash, Director
Office of Public Charter School Financing & Support

Date: [INSERT DATE]

Re: Policy for Annual Determination of Direct Loan Interest Rates for Charter Schools and Related Entities

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This memorandum will serve to establish a methodology to be used by the Office of Public Charter School Financing and Support (OPCSFS) to determine a reasonable, below market interest rate to charge for any loan disbursed from the Direct Loan Fund for Charter School Improvement (Fund) established pursuant to DC Official Code §38-1833.02. Interest rates will be based on a published federal government rate. An additional percentage will be added to this rate in order to recoup the annual administrative expenses paid for from Fund proceeds.

This methodology will allow for:

- Public transparency as to how the direct loan interest rates are established.
- Annual interest rate changes that reflect the movement of the overall financial markets. As interest rates in the overall market increase and senior lenders raise their rates, OPCSFS' rates will also rise. As interest rates in the overall market decrease and senior lenders lower their rates, OPCSFS' rates will also decrease.
- Compliance with federal and local law requiring interest rates that are below the prevailing market rates. *See D.C. Official Code §§ 38-1833.01 and 38-1833.02.*

INTEREST RATE SETTING METHODOLOGY PRACTICES – DETERMINING A COST OF CAPITAL

Commercial banks generally consider the following component when determining an interest rate to charge on a loan (cost of capital):

1. **The Cost of Funds**

   For banks, the cost of funds consists of the interest rates they pay on checking accounts, savings accounts, certificates of deposit, and other investment vehicles that serve as the source of the money they lend. For lending organizations whose funds have come in the form of a grant, the opportunity costs of these funds serves as the cost of funds. In this case, opportunity costs are defined as the cost of passing up the next best choice when making a decision. For example, if an asset such as capital is used for one purpose, the opportunity cost is the value of the next best purpose for which the asset could have been utilized.

2. **The Administrative Costs of the Program**

   The interest income from commercial loans is used to recoup the administrative expenses (i.e. salaries, training, etc.) associated with providing the direct loan or credit enhancement, including a reserve for any loan write-offs. This ensures the ongoing financial solvency of the funds.

3. **Shareholder's Return**

   The shareholder profit necessary to attract stockholders to the company.

OPCSFS' – DETERMINING THE COST OF CAPITAL

1. **The Cost of Funds**

   Since OPCSFS' direct loan and credit enhancement revolving funds were funded with grant monies, there is no cost associated with securing the funds but instead the interest rate should reflect the opportunity cost of the funds. In the case of OPCSFS, a Treasury note was selected to represent the opportunity cost. OPCSFS will use a five-year Treasury note because it has the same maturity as the required five-year term of the direct loan. Usage of this benchmark for the cost of funds is consistent with the benchmark used by some Community Development Financial Institutions (CDFI) that also receive grant funds.

2. **The Administrative Costs of the Program**

   OPCSFS management estimates approximately $130,000 in annual administrative expenses will be charged to the direct loan fund. Given the Dec. 31, 2018 outstanding loan balance of approximately $16,000,000, the additional interest rate necessary to be charged to recoup administrative costs would be .86 percent - rounded up to one percent.

   Direct loan write-offs or restructurings have not occurred over the last three years, a function of a stronger DC Public Charter School Board approval process and stronger underwriting practices. Therefore, OPCSFS does not propose to factor in any additional interest necessary to build a loan loss reserve will at this time. Interest income that is received via use of the five-year Treasury note will accumulate and can be used to offset any write-offs.

It should be noted that the one percent OPCSFS administrative add-on is significantly lower than the 2.50 to 3.50 percent that the CDFI and bank lenders add to their cost of funds. Higher staffing costs and employment of construction project managers and inspectors contribute to this higher cost.

3. **Shareholders' Return** – Not applicable in the case of OPCSFS.

   Lower administrative costs and no shareholders' return results in OPCSFS being able to offer below-market rates.

OPCSFS DIRECT LOAN INTEREST RATE SETTING METHODOLOGY

1. Interest rates are to be reset annually at the start of each calendar year.
2. The five-year Treasury note interest rate on the last day of the previous calendar year will be used as the cost of funds portion of the interest rate.
3. A percentage amount necessary to recoup the annual program expenses (currently one percent) will be added to the cost of funds interest rate and this rate will be rounded to the next highest .25 percent and this will be the interest rate charged over that calendar year.
4. The new interest rate will be published in the LEA Look Forward each January as part of an article discussing the availability of direct loan and credit enhancement funding.

The following example demonstrates how the interest rate will be developed. It should be noted that this methodology results in a lower rate than the 4.5 percent OPCSFS has charged over the last several years.

	5 - Year Treasury Rates *	OPCSFS Adminsrative Expenses **	Interest Rate	OPCSFS Published Interest Rate		
2013-02-08	**0.84**	**1.00**	**1.84**	**2.00%**		
2013-12-31	**1.75**	**1.00**	**2.75**	**2.75%**		
2014-12-31	**1.65**	**1.00**	**2.65**	**2.75%**		
2015-12-31	**1.76**	**1.00**	**2.76**	**3.00%**		
2016-12-30	**1.93**	**1.00**	**2.93**	**3.00%**		
2017-12-29	**2.20**	**1.00**	**3.20**	**3.25%**		
2018-01-02	2.25					
2018-01-03	2.25					
2018-01-04	2.27					
2018-01-05	2.29					
2018-01-08	2.29					
2018-01-09	2.33					
2018-01-10	2.32					
2018-01-11	2.32					
2018-01-12	2.35					
2018-01-16	2.36					
2018-01-17	2.39					
2018-01-18	2.43					
2018-01-19	2.45					
2018-01-22	2.46					
2018-01-23	2.43					
2018-01-24	2.43					
2018-01-25	2.41					
2018-01-26	2.47					
2018-01-29	2.49					
2018-01-30	2.51					
2018-01-31	2.52					
2018-02-01	2.56					
2018-02-02	2.58					
2018-02-05	2.50					
2018-02-06	2.52					
2018-02-07	**2.57**	**1.00**	**3.57**	**3.75%**		

* Economic Research Division
Federal Reserve Bank of St. Louis
5-Year Treasury Constant Maturity Rate, Percent, Daily, Not Seasonally Adjusted

** Estimated annual program expenses $130,000 divided by outstanding loan balance of $16,000,000 = .86 rounded to 1.00.