

Credit Considerations for Reaching Nonpoint Source SRF Borrowers

Prepared by



**The Council of Infrastructure Financing
Authorities**

Assisted by

Government Finance Group

CIFA Monograph No. 10

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ABOUT CIFA

The Council of Infrastructure Financing Authorities (CIFA) is a national, non-profit organization of state and local authorities providing financial assistance to meet infrastructure needs. CIFA seeks to: (1) encourage the exchange of information on infrastructure financing among and between the States, the national government and the private sector; (2) conduct research on issues, trends and events in the area of public finance; and (3) advocate sound public policies advancing infrastructure financing. The CIFA monograph series is intended to provide a national platform for the presentation of new ideas and analyses of issues affecting federal, state and local infrastructure programs. For additional information on CIFA and the monograph series, contact James N. Smith at (202) 371-9694.

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FOREWORD

*Increasingly, states are providing **State Revolving Fund (SRF)** loans to finance nonpoint source control projects. Borrowers for these types of projects are frequently not local units of government, but more often homeowners, small businesses, farmers, growers, dairyman and others in the private sector. Through the **Clean Water Action Plan** and other efforts, EPA is encouraging more SRF lending to implement nonpoint source controls among this community of borrowers.*

Moving into the area of private lending, however, presents a range of legal and practical considerations for the SRF administrator. Many states, for example, are prohibited by state law or policy from providing direct financial assistance to private parties, making it impossible for them to loan directly to a homeowner or a farmer for implementation of nonpoint source controls. And federally imposed limitations on the use of SRFs and the participation of private parties in the use of bond proceeds also create barriers for some expanded SRF uses. More daunting for the SRF administrators looking to venture into the area of private party lending are the credit considerations associated with this category of borrower. Unlike local units of government which can pledge either tax receipts or user revenues as a source of loan repayment, private party borrowers have neither. Consequently, credit considerations become paramount. This is a different type of lending and many SRF managers are not inclined to take on the disciplines and the potential exposures of a commercial lending operation.

Nevertheless, in our review we found that a number of states have adopted approaches to reach the private borrower which effectively circumvent federal and state limitations and insulate them from exposure to potentially weak credits. For the most part, states that are actively pursuing nonpoint source lending programs are reaching the private sector borrower through conduit arrangements with either commercial banks or sub-governmental entities such as irrigation or soil conservation districts, or in some cases agricultural marketing cooperatives. In these arrangements, the intermediary or conduit does the credit assessment and assumes exposure to possible default. Many of these are ingenious lending arrangements to reach this class of borrower, a tribute to the flexibility of the SRF program and the ingenuity of the program managers in adapting their lending to reach this category of borrower while at the same time protecting their SRF from exposure to uncertain credits. The adaptability of the SRFs also suggests the potential to reach a broader range of nonpoint source borrowers through

conduits such as municipalities seeking tradeoffs in a watershed between point and nonpoint source controls.

The purpose of this Monograph is to report on this development in some of the states that have pioneered in it, and to describe the elemental financial structure of the lending arrangement in the event other states may want to consider such lending.

*In addition, the Monograph also describes the emergence of a new type of SRF borrower. Nonprofit land conservation and protection groups are looking to the SRF for low-cost financing for securing environmentally critical lands and habitat to protect stream beds, lakes and estuaries from environmental deterioration or destructive uses. These new borrowers also present new credit considerations for the SRF lender, which may involve liens on land or property or recourse to the borrower's dues and other sources of income. For those states wanting to venture into this area of direct lending without the insulation of a conduit arrangement, Part II of the Monograph helps lenders assess the creditworthiness of different types of private borrowers, along with working examples in the Appendix of hypothetical credit assessments. While the examples are for clean water projects, this portion of the Monograph should also be of use to **Drinking Water SRF** managers in lending to the private sector.*

*Information in this Monograph on specific state lending practices was gathered from a CIFA survey. Financing for the project was partially supported by a grant from U.S. EPA. CIFA staff conducted the survey and prepared the report in Part I. The **Government Finance Group** prepared the material in Part II and the Appendix. The project was designed and conducted with the guidance of an advisory group of CIFA members, identified in the Appendix. We are grateful for the time, guidance and valued advice they provided.*

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INTRODUCTION	1
PART I.....	3
HOW DO NONPOINT SOURCES QUALIFY FOR SRF LENDING?	3
LEGAL AND PRACTICAL HURDLES TO NONPOINT SOURCE LENDING ...	4
DESIGNING NONPOINT LOAN SOLUTIONS	6
Partnering with a Commercial Lender	7
Public Agencies as Conduits	14
Involving Marketing Cooperatives.....	18
The Municipality as Conduit	20
Direct Lending.....	20
PART II	23
CREDIT ASSESSMENT	23
NON-PROFIT ORGANIZATIONS.....	24
HOMEOWNERS ASSOCIATIONS.....	28
INDIVIDUALS, HOMEOWNERS, AND FARMERS.....	29
PRIVATE FIRMS AND COMMERCIAL FARMERS.....	32
FINANCIAL ENHANCEMENTS AND INSTITUTIONS.....	37
APPENDIX.....	39
CASE STUDIES.....	39
Farmer Jones.....	40
Lake Harry Homeowners Association.....	44
Rock Ribbed Land Foundation.....	48
LIST OF STATE PROGRAMS AND CONTACTS	51
PROJECT ADVISORY GROUP	53

INTRODUCTION

The Clean Water State Revolving Loan Fund (SRF) has proven a vital source of financing for water pollution control projects. Since its creation in 1987, over 8,000 loans have been made for projects throughout the 50 states and the Commonwealth of Puerto Rico. The vast majority of these loans have gone to finance traditional point source control improvements in municipal sewage collection and treatment. But increasingly, some state SRF programs are making loans to finance nonpoint source controls, a source of pollution which EPA has identified as responsible for as much as 70 percent of current pollution loadings into the nation's surface waters. States report that as of June 30, 1999, 1,696 nonpoint source projects have been financed with SRF loans for a cumulative total of just over one billion dollars.

While the purpose of these loans is to address nonpoint source problems, most are still being made to municipalities and other local units of government. From a financial perspective these are still traditional SRF loans where the governmental borrower pledges tax or utility related revenues as a source of repayment. The loans may require some extra effort on the part of the lender to assure that the proposed project purposes are technically and physically achievable and that the projected revenue estimates for loan repayment are realistic. But, the essential structure of the loan and the creditworthiness of the borrower are no different from a loan to a municipality for a point source control project.

The nature of many nonpoint source water pollution problems, however, is making it necessary for states to make SRF loans to parties other than the traditional governmental SRF borrower, or to structure loans to those borrowers in different ways. The practices of farmers, growers, land owners and developers are identified as sources of nonpoint pollution. In addition, failing or inadequate septic systems make individual homeowners and small businesses a contributor to water pollution problems in many rural and un-sewered areas. And a new type of borrower is beginning to emerge in the nonpoint source area. Non-profit land conservation and environmental protection groups are beginning to look to the SRF as a low cost source of financing. Interest in securing environmentally critical lands and habitat to protect stream beds, rivers, lakes and estuaries against adverse modifications or land use practices that threaten water quality are the motivating factors. In at least two cases, the Nature Conservancy has used the SRF for financing to secure land and easements to protect riparian areas; an area of SRF borrowing that is likely to grow.

Even traditional borrowers, venturing into financing different types of environmental projects, may want to limit their liability. Local governments seeking to borrow from the SRF may wish to limit their pledge of revenues for loan repayment to those derived from a specific

development or other non-tax based revenues. This will be especially true where states use SRFs to finance the clean up and restoration of abandoned industrial sites – so called “brownfields.”

These new types of loans, whether to farmers, homeowners, non-profit groups, or local governments seeking to borrow without pledging general tax or utility revenue, present a challenge to the SRF lender. Essentially, this is lending to private parties lacking access to the security arrangements available to local governments. From the perspective of the SRF lender, it means applying a different set of credit considerations comparable to commercial lending. Questions about the source of loan repayment, loan security and collateral take on new significance.

States may also have legal constraints. Many are limited by law or state constitutional restrictions from providing financial assistance to private parties. A number of states have found it advisable to structure borrowing arrangements through public, quasi-public, or commercial conduits, in order to reach the community of private sector borrowers. In addition to overcoming legal impediments and creating effective conduits for lending to these parties, these arrangements may also help insulate the SRF from some of the credit exposure a direct loan might otherwise experience.

A number of states have pioneered in designing and implementing these SRF lending arrangements to reach nonpoint source borrowers. **California** and **Ohio** have structured loans to non-profit organizations for land preservation in critical riparian areas; **Delaware**, **West Virginia** and **Washington State** are making loans through conduits to assist chicken farmers and dairymen in implementing nonpoint source controls on their farm operations; **Minnesota** is in the forefront in designing lending arrangements for correction of failing septic systems; and to get at yet another agriculturally related problem of water pollution, Ohio has developed the “linked deposit” approach for lending to farmers through commercial banks.

There are examples, as well, in other states of lending arrangements that reach non-governmental borrowers, each with their own distinctive features. Our purpose here is to illustrate these examples, and explain their elemental financial structure. Other states wishing to employ the SRF as a source of financing for nonpoint source controls may find them adaptable to their own program needs. These state program examples are covered in **Part I**. For those states considering direct lending to private and non-profit entities, we have also included a section in **Part II** to help a lender assess the creditworthiness of that type of borrower, as well as working examples included in the Appendix of hypothetical credit assessment cases covering non-profit organizations, homeowner associations, farmers and private businesses.

PART I

HOW DO NONPOINT SOURCES QUALIFY FOR SRF LENDING?

The Clean Water Act is a point source control statute. But the amendments in 1987, creating the SRF loan program, provided that water pollution control problems attributable to nonpoint sources can qualify for SRF assistance so long as they are identified and included in the state's nonpoint source management plan authorized under Section 319 of the Act or the National Estuary Program's Comprehensive Conservation and Management Plans referenced under Section 320 of the statute. Eligible projects can include abatement of either ground or surface water pollution or projects designed to protect the resource from deterioration. The only statutory requirement is that the plan be reviewed and approved by EPA, and that the loan-funded project meets other requirements of Title VI for pollution abatement and financial reliability.

EPA wants States to do more nonpoint source lending and is encouraging SRF programs to identify, include and prioritize these projects in their integrated priority setting system. Unlike point source loans, which are limited to units of government, EPA has construed the Act and its legislative history to allow lending to "persons" for nonpoint source projects, in effect, greatly expanding the community of potential borrowers.

Examples of loan-qualifying projects include such things as manure storage facilities, no-till farm equipment and water conserving irrigation machinery, animal waste composting, wetlands restoration and protection, land mitigation banking, stream bank restoration, estuary protection, restoration of submerged aquatic vegetation, control of storm water run-off in unsewered areas, underground storage tank removal, failed septic systems, and landfill improvements or closures. As diverse as these projects may be, to qualify for SRF loans a source of repayment must first be identified. This can be a problem with private sector borrowers, who do not possess the taxing powers or access to user fees. In addition to practical limitations, states may also have their own legal constraints that limit their ability to make nonpoint loans.

LEGAL AND PRACTICAL HURDLES TO NONPOINT SOURCE LENDING

State Limitations

Many state constitutions or statutes prohibit the state from providing direct financial assistance to a private party. In those states, direct SRF loans to farmers, producers, homeowners or businesses are either prohibited or must be done through a public or quasi-public conduit. Other states, like Washington, have no legal limitations on such direct lending, but observe a state policy of not lending to private entities. Still others have statutory prohibitions on providing SRF loans for other than traditional point source control projects.¹ As lending through the Drinking Water SRF increases, states with such laws or policies may consider modifying them to reach borrowers of privately-owned drinking water systems, which are SRF loan eligible.

Federal Limitations

Though private parties are not eligible to receive SRF loans for point source projects, EPA has implemented the law to provide considerable latitude for the states to reach nonpoint source borrowers, including private entities. Still, some limitations are inherent in the use of the federal capital grant funds. Mainly these federally imposed limits can be effectively circumvented by a state wishing to reach a certain category of borrower.

The requirements imposed on the SRF by the Federal Office of Management and Budget (OMB) with respect to cash draws from the Treasury can inhibit some nonpoint source lending arrangements that involve deposits or dedication of loan funds into an account, as in the case of conduit lendings involving commercial banks. The OMB rules, aimed at maintaining federally committed grant funds in the U.S. Treasury as long as possible, provide that grant payments to the state will only be made for “incurred costs.” Strictly speaking, some of the conduit lending arrangements do not involve incurred costs to the SRF since the SRF funds are not actually expended but only on deposit in a commercial banking account. Additionally, some states may wish to avoid exposing the nonpoint source lender to the myriad of so-called “cross-cutting” federal requirements that may attach to the commitment of federal funds. To circumvent these federal limitations, many states are funding their nonpoint source lending exclusively from payments received on loan principal and interest. These funds, which are generally considered to be exempt from federally imposed restrictions applicable to first round grant dollars, are reaching sufficient levels in most state programs to cover a considerable program of nonpoint source lending.

¹ According to a survey conducted by the National Council of State Legislatures, of 33 states passing DWSRF implementing provisions in the 1997-1998 legislative session, 8 restricted lending to publicly-owned systems.

Another federal constraint is that imposed by tax law on the use of funds from bond proceeds. In those states which leverage their SRFs through issuance of tax-exempt debt in the bond market, federal tax laws place restrictions on the use of bond proceeds, especially with respect to private use of the money if the proceeds are those of a public purpose “governmental bond,” which is the case with the vast majority of municipal bonds.

Over the years, federal tax writers have placed increasingly stringent restrictions on the use of these bonds by state and local governments, especially where some benefit to the private sector might occur. Put briefly, a governmental bond must meet private activity use tests in which:

- 1) no more than 10 percent of the proceeds of the facility financed with the proceeds are used for any private business use (the “**business use**” test), and
- 2) no more than 10 percent of the principal or interest of the bond is directly or indirectly:
 - a) secured by any interest in property used for a private business use or payments in respect to such property, or
 - b) derived from payments in respect to property or borrowed money used for private business use (the “**security interest**” test) or, conversely, no more than 5 percent of the proceeds or \$5 million, whichever is less, is to be used to make or finance loans to non-governmental persons (the “**private loan financing**” test).

If a bond fails the above tests, it can still be a tax-exempt bond for purposes of providing wastewater treatment, but must be issued as a “private activity bond” (PAB) which have further state-by-state restrictions on the allowable volume of issuance.

The above described limitations on the use of tax-exempt bond proceeds while real, should not work a serious limitation on the use of leveraged SRFs to address nonpoint projects. There are ways around them, which can be handled on a case by case basis.

For example, since individual nonpoint source projects tend to be far less costly than municipal point source treatment, the 5 percent limitation may not work as a serious constraint on the use of bond proceeds. **PENNVEST**, Pennsylvania’s SRF lending authority, for example, limits on-lot treatment system loans to private landowners to 5 percent of the proceeds from their

bond issue. Since SRF bonds are usually in multiples of tens of millions of dollars, even five percent of the issue can be a significant amount for nonpoint source financing.

Another means of circumventing this tax law limitation in order to reach private sector borrowers is for the leveraged state programs to set-aside a percent of their SRF capital grant for direct loans. This requires separate accounting for the direct loans, but should not present a prohibitive problem for the SRF managers and, in fact, several states do it.

Practical Limitations: Credit Analysis

Perhaps most daunting for the SRF manager venturing into this new area of lending is the different type of criteria for credit analysis associated with this type of borrower. As mentioned above, nonpoint lending moves the program into the area of commercial lending where the creditworthiness of the borrower is paramount. Since, in most cases, borrowers seeking loans for nonpoint source control projects will not have a revenue stream from user fees or taxes to pledge to repayment, the capability of the borrower to repay the loan is the critical factor. This necessitates a careful review of the applicant's financial history, current situation and potential for future repayment. Details of this credit assessment are treated in **Part II** and additional materials on the application of analytical tools for such assessment are included in the **Appendix**.

DESIGNING NONPOINT LOAN SOLUTIONS

A number of states lead the way in structuring practical lending arrangements which surmount or reduce the hurdles to private sector lending noted above. For the most part, they involve conduit arrangements with a state or local governmental entity or with a commercial banking establishment. These conduits serve to facilitate lending to the private sector borrower while, at the same time, insulating the SRF from credit exposure as well as much of the administrative work involved in originating and monitoring the loan. These conduit-lending arrangements fall roughly into three categories, which we will characterize as:

- (1) **Partner with a commercial lender**
- (2) **Enlist another public agency to act as intermediary**
- (3) **Involve a cooperative or other producer related enterprise**

Partnering with a Commercial Lender

Forging an arrangement with a commercial bank is one of the more novel and probably more efficient methods for reaching private sector borrowers. **California, Minnesota and West Virginia** all have SRF lending arrangements partnered with commercial banks, but the concept, generally referred to as a “**linked deposit**” was developed by the **State of Ohio’s SRF**, which is co-managed by the Ohio Water Development Authority and the Ohio Environmental Protection Agency.

Linked Deposits: Under this arrangement the bank does what it is most qualified to do; assess the creditworthiness of the private sector borrower just as it would for any other potential customer. As a local banking operation or branch bank, it is far more familiar with the local economy, the exigencies of its cyclical change, and possibly with the actual financial situation of the loan applicant. This can be especially relevant with loans to the agricultural community where changes in production and crop prices can have significant effects on the repayment capacity of the borrower. Once the loan is made the bank also takes responsibility for the managerial tasks of loan servicing, monitoring, crediting and transferring repayments to the SRF. And most important, from the perspective of the SRF lender, the bank takes the credit risk. In the event of default the bank will do the “work-out” and initiate steps to recover their security interest. For those SRFs that leverage their funds in the bond market there is an added advantage. Since the bank assumes the credit risk, the linked-deposit arrangement has no implications for the lender’s credit ratings.

Why would a commercial bank take on all of this responsibility as well as the credit risk? Put simply, to get the use of the SRF funds at a greatly preferred rate. This happens in several ways.

With the linked deposit, the SRF deposits funds in a commercial bank account at a substantial reduction in interest from what the bank otherwise pays depositors. In return for the use of this money at a reduced rate of interest, the bank agrees to make loans to farmers for approved **Best Management Practices (BMPs)** projects. The farm loans are still below commercial market rates as the bank recoups the spread between what it pays for the use of the SRF funds and the interest rate of the loan; in most cases 3 percent. In this arrangement, the commercial bank takes full responsibility for the credit evaluation of the borrower, prepares and executes the loan agreement, disburses the funds, monitors and services the loan and takes the credit risk of possible repayment problems or actual defaults.

Under the linked deposit arrangement, the SRF gets a nominal return on its investment in the form of certificates of deposit (CD), which in the case of Ohio is for the exact amount of the

farm loan, while avoiding the credit exposure and the task of managing the loan. It ties up the SRF funds in a low interest earning account for the period of the loan, which varies depending on the needs of the applicant, but never exceeds 20 years. The interest on the deposited funds is roughly approximate to what the state would receive from a SRF loan to a municipality, so the net loss is de minimis.

The CD does not serve as loan collateral and is never in danger of being lost to the fund. When the loan matures the CD account is closed and the funds returned to the SRF to be used again. As deposits in a commercial bank, the CDs are covered by FDIC insurance up to a maximum of \$100,000. For additional coverage the State requires the bank to establish an exclusive collateral fund providing 105 percent coverage for amounts over the FDIC insured limit. This further limits the SRF's credit exposure. In Ohio the linked deposit loan program has been a source of financing for over 100 nonpoint source control projects totaling approximately \$3.5 million.

Compensating Balances: A variation on the linked deposit approach is being fashioned in **California** where the SRF program has initiated an arrangement with **Bank America** originally fashioned around a "compensating balances" approach. Under this lending arrangement, which is used with some Housing and Urban Development (HUD) loan programs, the State deposits SRF funds in the bank as a short-term investment. The bank pays the going rate to the state for the use of the funds but as loans are approved, the amount of the balance of the deposit on which interest is calculated and paid, declines by the amount of the loan. For example, a deposit of \$500,000 in the bank would earn the current rate of interest being offered by the commercial bank for that size deposit. The interest would be calculated on the full \$500,000. As a loan was made, say for \$300,000, to implement a BMP project, the balance on which the interest would be calculated would decline to \$200,000. The half million dollars of SRF funds would continue to be tied up in the bank account, but interest would only be paid on a portion of it. As principal was paid on the loan, the interest earning increment would increase.

Under this arrangement the bank takes the full responsibility for the credit analysis, loan services and credit risk. The SRF funds are never at risk, although that portion of the deposit encumbered by the loan is not working in the sense of returning earnings to the SRF. From this perspective, it amounts to an interest free loan. While assuming the responsibilities for the credit risk and loan servicing, the bank gains the use of the SRF funds at a substantial discount and may also charge the borrower a small interest fee.

In fact, the compensating balance method has never been fully implemented in California's nonpoint source control program due to concerns from the State Treasurer's Office that the crediting and accounting necessitated by the continually changing balances in the loan

**SUMMARY OF WPCLF LINKED DEPOSIT PROGRAM
OHIO ENVIRONMENTAL PROTECTION AGENCY**

Basic elements of the WPCLF Linked Deposit Program are as follows:

- A farmer develops, with county Soil and Water Conservation District staff, a soil and water conservation plan that conforms with a watershed management plan developed for the watershed in which the farm is located. The watershed management plan is consistent with and helps implement the CWA •319 management program for the state of Ohio.
- The farmer next obtains a Certificate of Qualification from the Board of Supervisors of the county SWCD, specifying the improvements in the farm's soil and water conservation plan which are eligible for WPCLF Linked Deposit Program funding, in conformance with the Memorandum of Understanding between Ohio EPA and the county SWCD.
- The farmer then goes to one of the local area banks participating in the WPCLF Linked Deposit Program, who have signed Participating Agreements with the Ohio EPA and the Ohio Water Development Authority (OWDA).
- Upon presentation by the farmer of the Certificate of Qualification, the bank evaluates the creditworthiness of the farmer using its own loan criteria. If the farmer qualifies for a loan, the bank then enters into a loan agreement with the farmer.
- The bank sends Ohio EPA an investment request form, which identifies the farmer, the terms of the loan, and contains a copy of the farmer's Certificate of Qualification.
- Ohio EPA and the Ohio Water Development Authority, if the investment request is approvable, deposit with the bank through a certificate of deposit funds from the WPCLF equal to the face value of the loan with the farmer, for a term of years equal to the term of the bank's loan with the farmer, but in no case longer than 20 years. In accordance with the Participating Agreement between the bank, Ohio EPA, and OWDA, the interest rate on the certificate of deposit is set at 3% less than U.S. Treasury Notes and Bonds rate for notes and bonds with a comparable term of years, but in no case will the interest rate on the certificate of deposit be less than 3%. The repayment schedule in the certificate of deposit contains semi-annual payments of principal and interest to the WPCLF.
- The interest rate of the bank's loan to the farmer is reduced below the bank's normal rate of interest by the same amount as the discount the bank received from the WPCLF.

and deposit accounts would be too much trouble. Instead, the State and Bank America initiated a modified version of Ohio's linked deposit program. Unlike Ohio, where the state makes CD bank deposits to match the actual amount of each loan, the California SRF makes one large deposit with Bank America and draws against it as loans are executed. The Bank pays the SRF the regular commercial borrowing rate on the deposit, less the amount of the loan subsidy (usually 3 percent) which the state wishes to pass through to the nonpoint source borrower. In addition, the Bank charges a loan origination fee, which is rolled into the loan. Mainly, this conduit arrangement is being used to reach private landowners in the Lake Tahoe basin for the implementation of small watershed protection improvements.

Minnesota's Loan Participation Method: Under an approach referred to as the “loan participation method” the state and the commercial bank team up to finance equal shares of a loan to private owners of lake resort property for replacement of failed septic systems. The bank charges its current commercial rate while the state charges a reduced rate, fixed now at 2 percent. The result is a blended rate of interest to the borrower for the full cost of the project. Mainly, these are ten-year loans for a combined average amount of \$27,680.

The bank assumes responsibility for the analysis of the borrower's creditworthiness and the risk for its share of the loan. It also takes on the responsibility of loan services for the total loan, remitting to the states their share of the payments. The SRF, on the other hand, becomes a direct party to the loan, performs its own credit analysis and shoulders its share of the risk. Both lenders establish a primary lien on whatever collateral the borrower pledges. In the event that the borrower is a corporation or partnership, personal guarantees are required. Because the state becomes a direct party to the loan, some states may not find this a totally attractive option.

Minnesota has another variation on nonpoint source lending, described later, which can indirectly involve commercial lenders through a public agency conduit.

West Virginia Model: West Virginia has developed a SRF loan arrangement to provide financing to farms for the implementation of BMPs. As approved by the State Soil Conservation Agency, loan qualifying BMPs include dead bird composting on chicken farms, manure and soil management systems in concentrated animal feeding areas and the creation of vegetative filter strips to remove sediment, organic matter and other pollutant run-offs.

Under the West Virginia arrangement, commercial banks are recruited as participants. According to the State, the inducement to the bank is two-fold. First, it helps solidify their banking relationship with the producers. Probably more important, the bank gets free use of the SRF money to make low-interest bearing loans. The interest earnings on the loans, which have been approximately 2 percent, are retained by the bank.

From the State's perspective, the arrangement insulates it from any credit exposure and relieves it of any responsibilities for credit evaluation and lien search, loan disbursement and servicing, while accomplishing the development of nonpoint source controls. The SRF funds are provided directly to the bank once the applicant is qualified by the Soil Conservation District. The amount of these individual loans is limited to \$100,000 per applicant. Once made, the project must be completed within 180 days. Borrowers must agree to obtain broad form hazard insurance on any loan-funded structures or equipment. Repayments are made to the bank and passed back to the SRF to cover the principal amount of the loan.

Table 1 (p.13) compares the several major commercial conduit arrangements on the basis of their cost to the SRF, the level of credit exposure to the SRF lender and the loan and management service costs to the state, which in every case are absorbed by the commercial bank. The table also describes the inducement provided the commercial establishment to serve as conduit in these lending arrangements.

Other Variations: The **State of Missouri** has a variation on the West Virginia approach for extending loan financing to animal waste treatment facilities. It involves the commercial banking sector, but unlike West Virginia, the bank only originates the loan. Once completed, the State, acting through the Missouri Agriculture and Small Business Development Authority (MASBDA), buys out the loan and refinances it with SRF funds provided by the State SRF program managed by the Department of Natural Resources. SRF funds are provided to the MASBDA at 1.8 percent to cover a group of bank loans refinanced at 5.3 to 5.8 percent. The spread covers the administrative costs of arranging and managing the farm loans, as well as funding a default reserve. Refinanced loans are for 10 years.

Presumably, if the commercial lender has already made the loan, they found the borrower creditworthy, thus relieving the State of a major credit check. Even so, the University of Missouri Agricultural Extension Service reviews the loan and the borrower's credit.

Loan security is provided by the default reserve fund and, in the case of contract producers, the producer may pledge the product payments as a repayment stream, comparable to the cooperative arrangement described elsewhere in this section. There may also be assignment of federal payments due the farmer such as target price deficiency or Conservation Reserve Program (CRP) payments. The MASBDA may also require a first or second deed of trust. In addition to the interest charges, applicants are assessed a small application fee and a loan participation fee equal to one percent of the amount of the loan.

Pennsylvania's SRF program has a similar lending arrangement for reaching on-lot sewage disposal systems. Using a conduit arrangement with another State agency, the Pennsylvania Infrastructure Investment Authority (PENNVEST) provides SRF funds to the State Housing Finance Authority to buy loans originated with commercial banks for on-lot sewage improvement systems. The on-lot borrower applies to the bank, which does the credit analysis and makes the loan. Once made, the Housing Authority buys the note from the bank, which is then transferred to PENNVEST -- although the Authority continues to serve as intermediary, collecting payments and transferring them to the SRF --and repays the SRF with the repayment stream from the private borrower. The Authority retains a servicing fee of $\frac{3}{4}$ of one percent of the principal balance of each loan to cover their costs for loan servicing. Security for the loans is

the same as the standard requirements of the commercial bank, much like a home mortgage or equity lend line, with assignment of land and property to secure the loan.

In this arrangement, PENNVEST, as the ultimate holder of the note, bears the credit risk, ameliorated significantly by the credit check conducted by the commercial bank and the transfer of the lien on the borrower's property. For its role, the bank charges an up-front fee of several hundred dollars to originate the loans, which are made at market rates. PENNVEST reports that demand for these loans has been disappointing.

Table 1
Impact on the SRF from Commercial Bank Conduit Loan Arrangements

	Cost to the SRF	Level of Credit Risk Exposure	Loan Management/Serviceing	Inducement to Bank Participation
Ohio (Linked Deposit)	Approx. 3% below market return on bank invested funds	0	---	Use of SRF funds at discount
California (Linked Deposit)	(as above)	0	---	Use of SRF funds at discount plus loan origination fee
Compensating Balance*	Zero return on loaned funds	0	---	Free use of SRF funds plus loan origination and interest charge
West Virginia	Zero return on obligated funds equal to amount lent	0	---	Free use of SRF funds plus 2% interest loan charge
Minnesota (Loan Participation)	Below market (2% interest) loans	100% on state's loan share	---	Full commercial rate on loan plus state partner in the loan

** not actually implemented*

Public Agencies as Conduits

In a number of cases, state SRFs are employing public or quasi-public agencies as actual conduits to reach borrowers that might otherwise be inaccessible. In states where law or policy prohibits the SRF from directly providing financial assistance to a private party, these public entities serve as an effective conduit to the borrower. Most commonly, States have enlisted counties or special purpose public districts such as soil and water conservation or irrigation districts to reach agricultural borrowers. In these cases, not only do the conduits become the borrowing entity, but also provide experience and expertise on farm management and conservation practices. Based on their knowledge of agricultural practices, they can provide familiarity with the economics of farm operations, which helps assess the practicality of the proposed abatement project as well as the repayment capacity of the borrower.

In most cases, these public conduits assume the credit exposure and identify the source of repayment (see Table 2, p.16). Security for these loans is provided in different ways. Irrigation districts, which borrow to purchase water saving irrigation equipment that will reduce run-off and soil erosion, pledge the lease-fee charged to the farmer for use of the equipment. Still others pledge revenues from the sale of the quality-improved water.

In **California**, the SRF made a \$10 million loan to Mercer County to assist the financing of dairy nonpoint source controls. The proceeds, lent for 20 years at 2.6 percent, is passed through the county for “mini-loans” to dairy operations in its jurisdiction. The County, which is responsible for repayment to the SRF, performs the credit analysis using lending procedures developed by its own Economic Development Department. The farm loans are to be repaid to the County with proceeds from the dairy and farming operation and securitized with County liens on the private property.

Minnesota, while not restricted from private party lending, has a substantial SRF lending program for funding Agricultural BMPs through public conduit arrangements. Millions of dollars in SRF funds have been directed to these nonpoint source problems. As structured, the lending arrangements involve a local unit of government, which uses the funds to implement the agricultural provisions of their local water plans. The SRF funds are made available through a no interest loan to the local unit of government and a “local lender” who may be the local unit of government, a private lender, or a non-profit economic development organization approved by the Department of Agriculture.

The local lender becomes the effective agent for the loan, reviewing the credit application, executing the loan, dispersing loan proceeds and collecting loan payments. For that service, the local lender is allowed to charge up to 3 percent interest and collect a one-time loan

origination fee of one-half of one percent. The repayment stream on the loan during the first 10 years of the 20-year loan period is used to fund additional BMP loans. At the end of the 10th year the local lender must begin to repay the loan to the state, and by the 20th year the full amount of principal must be repaid, as well as any accrued interest on the principal.

Liability for the loan rests with the local lender and with the municipal or county government, which must provide the state with a general obligation (GO) pledge.

The Minnesota BMP financing program is always implemented through a local public agency. In the case of farm loans these are often local soil conservation commissions or districts which cooperate as a technical partner in the arrangement, recruiting the farmer's involvement, reviewing and certifying the structural project design and operability of the completed project. They can also be county governments or their designee with more expertise in farm soil and water conservation and operational practices.

Another variation on the public conduit approach is **Minnesota's Clean Water Partnership** program for lending through the Minnesota Pollution Control Agency. These are SRF loans to local units of government including counties, cities, watershed districts and townships. Loan funds can be used to implement control practices of the local governmental unit or can be re-lent to private parties for BMPs. In any case, the local government is the borrowing entity entering into the loan agreement. It must provide the state with a general obligation note as security for the loan, except in cases where the local unit of government, such as a Joint Powers Board, lacks taxing capacity. In these cases, the borrower must partner with another unit of government that can meet the loan security requirements.

The loans are for average terms of ten years for amounts ranging from \$150,000 to \$1.7 million. The state agency does a credit analysis of the local governmental borrower including a review of its net indebtedness. The security of the borrower's general obligation note, which must be reviewed by a bond counsel to ensure it is binding, significantly shields the lender from most credit risk.

The **New York State Environmental Facilities Corporation (EFC)** has made a SRF loan to a private enterprise through the conduit of the Wayne County Water and Sewer Authority. Although not strictly a nonpoint source project, the arrangement employed by the state is instructive and could be adaptable to reaching private sector nonpoint source borrowers. The loan is a 20-year term for \$9.2 million to the County Authority, the proceeds of which are used by the County to finance upgraded wastewater treatment equipment for a commercial food processing operation. The upgraded facilities will actually be owned by the County Sewage Authority with a sale/lease-back arrangement to the private food processors.

The County Authority entered into an agreement with the producer requiring payment of user fees in an amount sufficient to satisfy the SRF debt service obligation and related administrative costs. The payments are made to the County and passed through to the EFC. The County, for its part, is a financially passive player in the arrangement and unlike most of the other conduit loan arrangements, does not share in the credit risk. The EFC performed the credit analysis, and takes the credit exposure. As debt security, it has taken the senior creditor position on the loan with coverage in excess of 30x. Because of the private involvement in the arrangement, EFC, which leverages its SRF in the bond market, did not make the loan from bond proceeds, but from recycled loan funds.

Another conduit designed to reach private borrowers is that created by the **State of North Dakota** to provide financing for improved irrigation equipment for farming operations. The North Dakota SRF (**the State Municipal Bond Bank**) made a loan to a sister state financial institution, the **Bank of North Dakota (BND)**, in the amount of \$1.5 million, to establish the North Dakota Irrigation Loan Program. Farmers involved in irrigated agriculture can apply to the BND for a loan to finance water conserving systems, water source development equipment, and water efficient delivery systems. Approval of loans for up to \$50,000 is contingent on assurances of the efficiency of the proposed improvements, the land use practices and availability of dependable sources of water.

To financially qualify, the farmer must meet BND standard credit criteria including demonstrated repayment of debt. SRF funded loans from the BND are limited to 10 year terms at rates of 5.5 percent, plus a 1 percent origination fee. Under this arrangement BND assumes all credit analysis and credit exposure and may require collateral coverage. Repayment by the Bank to the SRF is not dependent on farm loan repayment. The SRF has no credit exposure for these loans and no responsibility to check the applicant's financials. The BND does that. In return the BND retains 3 percent of the interest earnings from the farm loans, returning the other 2.5 percent to the State Bond Bank, where one-half of one percent is retained to help cover administrative costs and 2 percent returned to the SRF to finance additional loans.

Table 2
Public Agency Conduits

State	Lending Conduit	Loan Recipient	Credit Assessment	Credit Exposure	Source of Repayment
California	County Government	Dairy Farms	County	County	Farm Income
	Irrigation District	Farmers	Irrigation District	Irrigation District	Equipment Lease Income
Minnesota	Local Unit of Government	Farmers	Local Government	Local Government	Farm Income
North Dakota	Bank of North Dakota (State Bank)	Farmers	State Bank	State Bank	Farm Income
New York	County Water and Sewer Authority	Food Processor	State SRF	State SRF	Lease-back Income
Pennsylvania*	State Housing Authority	Homeowners	Commercial Bank	State Housing Authority and SRF	Homeowner Payments
Missouri*	State Development Authority	Farmers	Commercial Bank and State	SRF	Farm Income

** also involves a commercial lender as loan originator*

Involving Marketing Cooperatives

Two states, **Delaware** and **Washington**, have structured innovative farm lending arrangements with farm marketing cooperatives. When the cooperative is the recipient of the loan, it has the capacity to pledge co-op stock as debt security and a stream of farm revenue from co-op payments to service the debt.

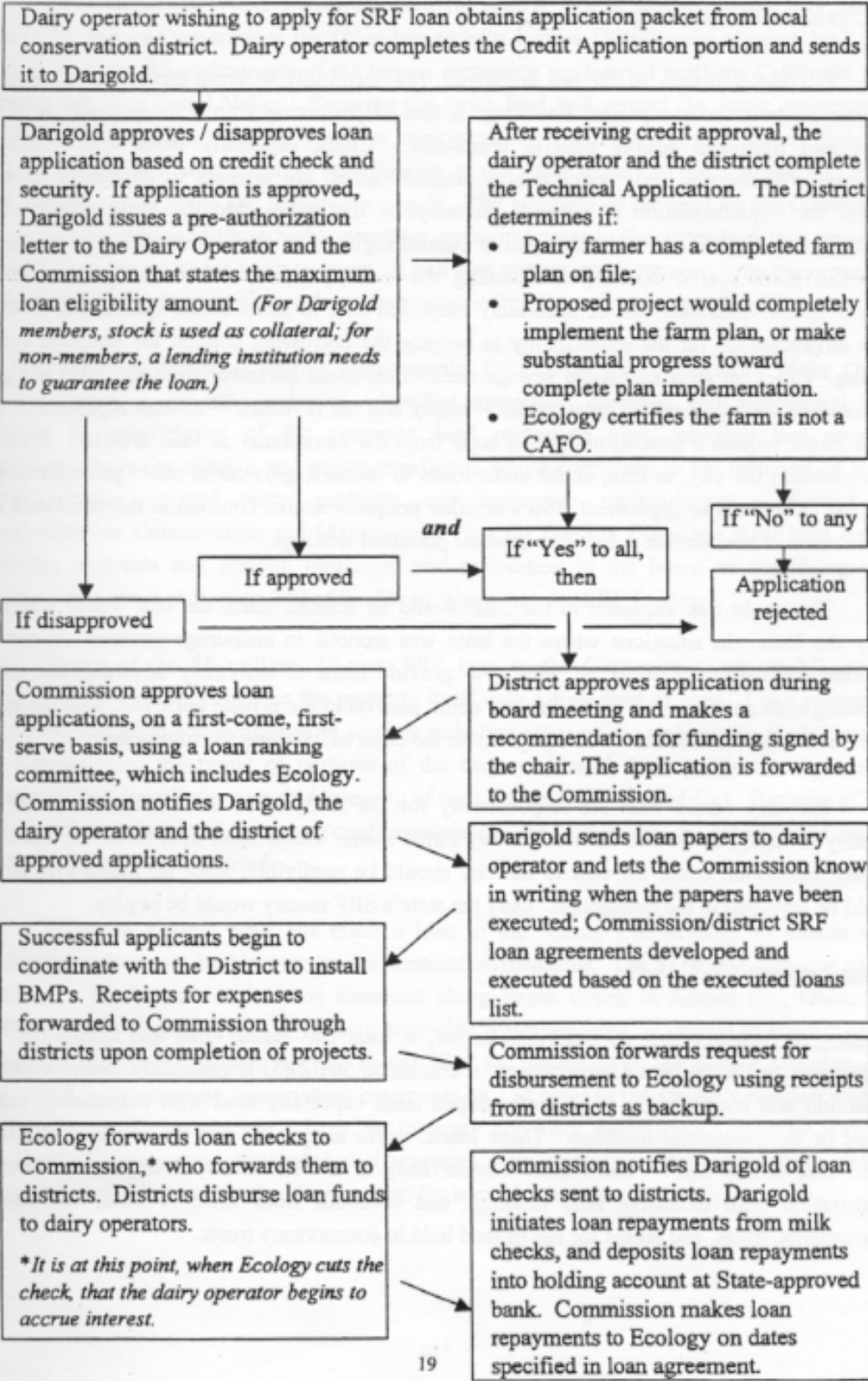
The State of Washington has a policy of not lending directly to private parties. To reach dairy farmers the SRF lends, via the State Conservation Commission, to Dairygold, a dairy farm-owned cooperative, to finance dairy farm waste management projects. The loan is actually to the State Conservation Commission, which pledges State appropriated funds as security. The Commission enters into an agreement with the cooperative, which participates in the arrangement as a loan agent, performing credit checks on the participating farmers, verifying the sufficiency of the farmers co-op stock as additional security, and providing servicing of the farm loans by actually deducting the loan payment from the co-op members' dairy revenues. For its part, the co-op charges a 1.25 percent loan origination fee and collects 3 percent annual interest on the loans, which are for a 5-year duration. The farmer can borrow up to 75 percent of the value of their unencumbered preferred co-op stock. Dairy farm applicants who are not members of the cooperative must find a financial institution willing to guarantee their loan and sign off on their credit.

Once this arrangement is structured and in place the State SRF's role is limited to (1) awarding the grant to the Conservation Commission; (2) inspection and certification by a Department of Ecology staffer, that the proposed project complies with Department standards for BMPs; (3) reimbursement of loan funded project costs to the Commission which in turn provides the funds to the dairy farmer and; (4) receiving and accounting for the repayments from the dairy cooperative.

Delaware has a comparable arrangement with a couple of dairy farm cooperatives in their State. Like Washington, the Delaware co-ops provide credit checks, loan security in the form of co-op stock and loan repayments from a deduction of the farmer's co-op revenues. But since Delaware is able to lend directly to private entities, they do not involve another conduit, such as a conservation district, as the borrower. For higher risk loans Delaware does enlist the help of the USDA Farm Service Agency to perform credit analysis, and in addition to a lien on co-op stock, requires a lien on property as well as hazard insurance.

Flow Chart

Washington SRF Dairy Waste Loans



The Municipality as Conduit

A conduit option so far not employed, but seemingly offering strong possibilities to advance nonpoint source project financing, is that of partnering with a municipality to affect **point and nonpoint source control trade-offs**. Cities, especially those with municipal wastewater discharges into “water quality limited” areas, are anxious to encourage or even require the implementation of controls on nonpoint discharges into the same waters. The alternative, under the current water quality control regimen, is to further ratchet down on the permitted point source discharges, including the municipalities. Where nonpoint pollution sources in the watershed can be accurately identified and, to some extent quantified, it would seem advantageous for the municipality to become the borrowing conduit for nonpoint source lending. Cities, or their municipal sewage authorities, could borrow from the SRF, pledging the standard securities of the government -- utility and tax revenues -- to loan repayment. The SRFs might require a general obligation bond from the community as loan security. With the loan proceeds the city, in turn, could make loans to farmers, growers or other privately-owned land use operations to implement BMPs or other nonpoint source controls in the watershed that would result in measurable reductions in water pollution loadings.

The credit risk exposure to the SRF would be limited, since the city would pledge to repay the loan. In situations where the state was anxious to encourage increased control of nonpoint sources, they might be willing to provide loans at extremely advantageous terms, including even zero interest, which the city could pass on to the private borrower, with perhaps a small loan origination fee or surcharge to cover the costs of handling the transaction.

The city would bear the responsibility for the analysis of the borrower’s credit and capacity to repay, as well as the risk for any failed loans. Aside from this, however, and some limited transaction costs, the cost to the city should be negligible, since no actual city dollars would be involved in the transaction. Only the state’s SRF money would be in play.

Direct Lending

Lending to Non-profits: As described earlier, at least two states, Ohio and California, have made loans to the **Nature Conservancy**, a charitable 501(c)(3) organization dedicated to the protection and conservation of underdeveloped land, especially land with outstanding natural scenic or environmental qualities. These loans, while unique, do not involve any significant credit risk to the SRF. The Nature Conservancy is a well-endowed, large member-based organization with extensive land holdings and revenues from member dues, earnings on endowments, trusts, and leases for use of land held in conservancy trusts.

The **California Water Resources Control Board**, which administers the SRF, made a loan to the Nature Conservancy for \$8 million to help acquire 13,000 acres of ranch land in the Cosumnes River Watershed, one of the largest remaining un-dammed northern California rivers flowing into the Central Valley. Securing the ranch land will protect the water resources and wildlife habitat within a highly sensitive ecological area of the Cosumnes River Watershed which, if developed, would lead to deterioration of the water quality in the drainage and loss of high quality vernal pools and valuable wetlands. The purchase of the land by the Conservancy will ensure protection of these highly sensitive ecological areas in the watershed, thus protecting the quality of the water for years to come. It will also protect water supplies from overgrazing or conversion of rangeland to vineyards or development from an encroaching urban fringe.

In meeting the legal lending requirements, the Central Valley Regional Water Quality Control Board, a sub-state authority, identified municipal, domestic and agricultural water supplies as beneficiaries of the proposed land protection plan, advising that proposed improvements in the riparian and stream conditions would contribute to the recovery of stream water supplies, ground water recharge and freshwater replenishment. Further, the Comprehensive Conservation and Management Plan for the San Francisco Bay/Delta Estuary identifies wetlands and riparian protection and restoration in the Basin as qualifying under Section 320 as well as Section 319 of the Clean Water Act, for SRF funding.

Terms of the \$8 million, 10-year SRF loan to the Conservancy are at 2.2 percent. Security for the loan is a lien on the property itself with a first deed of trust. Loan repayments are anticipated from a combination of sources including other public and private funds raised by the Conservancy, the resale of portions of the improved ranch land (subject to agricultural easements that specify the type and intensity of uses the land can be used for). Because of these security arrangements and the strong credit position of the Conservancy, no actual credit analysis of the borrower was conducted.

Likewise, **Ohio's SRF** has made a loan to the Nature Conservancy to ensure water quality through stream bank protection and restoration measures. The \$110,000 loan was used to purchase a permanent conservation easement along Brush Creek in Adams Co., Ohio. The creek, which is classified as a significant statewide water resource, is known to contain certain endangered species of aquatic life and is identified for protection in the State's 319 plan. The five-year loan to purchase conservation easements on 154 acres in the stream's riparian area was provided to the Conservancy at 3.2 percent interest. The State, performing a financial review of the Nature Conservancy, concluded that revenues from dues and gifts were substantial and sufficiently reliable to assure loan repayment. No securitization was required.

Other Direct Lending: The **State of Delaware**, which has no restriction, legal or otherwise, on lending to private parties, has established a direct lending program to homeowners for septic system repair. Loans of up to \$10,000 are made directly to the individual homeowner from the SRF, managed by the Delaware Department of Natural Resources and Environmental Control. The loans are at 3 percent interest for up to 20 years.

In this lending program the State takes responsibility for credit assessment of the homeowner and full credit exposure. For security, the State places a lien on the improved property. More than 100 individual septic systems have been repaired under this nonpoint source control lending arrangement.

The **Pennsylvania Infrastructure Investment Authority (PENNVEST)** makes direct loans to private sector borrowers for improvement in drinking water systems serving the public. While these are not Clean Water SRF nonpoint source control projects, the direct lending arrangement of the Pennsylvania Agency and its process for credit review have served as a prototype for other state SRF lending programs and could have application to nonpoint source lending as well. For the first stage of the credit analysis, PENNVEST contracts with a Certified Public Accounting firm to conduct a comprehensive financial analysis of the most recent three years of the applicant's financial statements (see p. 35 for a detailed description of the credit evaluation criteria).

PART II

CREDIT ASSESSMENT

Evaluating the creditworthiness of non-governmental borrowers is new territory for SRF managers, made more difficult by the wide range of types and sizes of these potential borrowers. A SRF manager must be able to evaluate each loan request on a case by case basis. This section is designed to give managers the necessary concepts and identify the tools to make these evaluations.

A manager of a state revolving loan fund must look at many aspects of the proposed project when deciding to make a loan. The three key capacity areas that should be evaluated when reviewing a loan application are **managerial**, **technical**, and **financial**. The managerial capacity of the organization requesting the loan refers to the applicant's overall experience and demonstrated ability to plan and control the borrower's operations and financial integrity. A review of the technical capacity of the infrastructure system and proposed project must be completed to make sure that the technology is appropriate and operations are likely to be efficient and affordable. While both the managerial and technical areas of analysis are important to the success of a proposed project, the following section focuses on the financial capacity and the type of review that should be performed to determine the ability of the organization to repay current and future loans.²

This discussion is broken down into four types of potential borrowers:

- **non-profit organizations;**
- **homeowner associations;**
- **farmers/individuals**
- **private firms.**

In addition, a discussion of means to enhance borrower's creditworthiness through letters of credit or insurance with commercial providers is included.

² Source: Community Development in Oregon, Safe Drinking Water Revolving Loan Fund, Program Guideline & Applicant's Handbook, August 1998

NON-PROFIT ORGANIZATIONS³

Non-profit organizations are created to provide socially desirable services without profit earning objectives. They have no ownership and any excess of revenues over expenses is used to enlarge their service capacity. They are financed by contributions and earnings for assets and sales of services. They are chartered by states and usually enjoy tax-exemption from most taxes, including IRS Sec. 501 (c)(3) classification as charitable institutions. Non-profit organizations are classified as charitable organizations 501(c)(3) by the Federal Government. Various trade groups, co-operatives and societies may engage in activities that support environmental issues. Although they have no ownership by private individuals or profit motive, non-profit associations work in a business-like fashion, providing services, employing people, and owning assets.

To review the financial viability of a non-profit organization the last three years of financial statements along with the operating and capital budgets must be obtained. Audited financial statements should be required when dealing with larger firms and organizations and where an audit has been done (audits are often required if the organization does grant or contract work for governments). However, for smaller entities and individuals financial statements will not be audited. To do so would be expensive. Other documents that may be helpful included past federal and state tax filings, such as the Federal Income Tax Form 990.⁴

Credit Ratings

Larger non-profit organizations may have received credit ratings from one of the major credit rating firms, Standard & Poor's, Moody's, and Fitch. If an organization receives an investment grade rating the organization is highly likely to repay future debt commitments. However, a formal credit rating should not preclude a manager from conducting his or her own credit analysis. When an organization assumes larger amounts of debt it may have a negative effect on the creditworthiness and subsequent rating of the non-profit. A credit rating should be used in conjunction with a manager's own analysis.

If one of the major credit rating companies has rated the potential borrower, the lender can access the credit rating. A lender may contact the rating agencies to determine if a rating has been assigned and if there is an accompanying report. If an organization is not currently rated, if

³ Sources: Financial Management for Non-profits, The Complete Guide to Maximizing Resources and Managing Assets, Jae Shim and Joel Siegel, Chapter 4, Financial Statement Analysis and Avoiding Financial Distress, Non Profit Organization, Analysis of the Balance Sheet

United Way Checklist of Organizational Indicators, The Management Assistance Program for Non-profits homepage, http://www.mapnp.org/library/org_eval/uw_list.htm

⁴ Non-profits may pay taxes on "unrelated" income they earn. The federal tax returns contain balance sheets, as well as summaries of revenues and expenses.

requested a rating agency may assign a rating. To obtain a rating or a rating report the credit rating companies can be contacted. The three major agencies are:

- 1) Fitch IBCA, Inc.
One State Street plaza
New York, NY 10004
(800) 753-4824
- 2) Moody's Investors Service
99 Church Street
New York, NY 10007
(212) 553-1658
- 3) Standard & Poor's
25 Broadway
New York, NY 10004
(212) 208-1199

Liquidity Analysis

Liquidity is important in evaluating the financial stability of a non-profit organization because it illustrates how quickly an organization can turn assets into cash. A non-profit's "restricted" funds should be excluded when evaluating liquidity because they are not available for use. The seasonality of cash flow is important because intermittent lack of cash flow may result in liquidity problems.

Liquidity Factors and Ratios

1. *Working capital.* Current assets less current liabilities. Current assets are those that are due (available in cash) within one year and current liabilities are those that must be paid in one year. The more working capital an organization has the greater its liquidity. Care must also be taken as to whether assets or liabilities are generally available or restricted to certain uses.
2. *Current ratio.* *This ratio equals:*
$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The higher the ratio the greater the liquidity. At a minimum the current ratio should be 2:1.
3. *Quick ratio.*
$$\frac{\text{Current Unrestricted Cash Assets}}{\text{Current Unrestricted Liabilities}}$$

Not all assets are equally liquid. Current assets that are inventory or prepayments of goods and services cannot be easily turned to cash. The quick ratio concentrates on cash-equivalent assets. The higher the ratio the healthier the organization. The quick ratio shows the extent to which current liabilities can be paid from cash and short-term investments if cash flow stops. This ratio should be at least 1:1.
4. *Cash flow to total debt service.*
$$\frac{\text{Net Income After Operations} + \text{Depreciation}}{\text{Total Principal and Interest Due}}$$

This is an important ratio because it indicates how much internally generated cash is available to pay for annual debt service. It should be at least 2:1. A higher ratio indicates better liquidity in that cash is being generated from operations.

Analysis of Liabilities

The current debt outstanding of a non-profit organization is important to its ability to repay current and future debt obligations. Short-term debt may be used to pay cash flow needs. Longer-term debt raises questions about the ability to repay debt over an extended period of time. Key points of outstanding long-term liabilities, which should be reviewed, include:

- Interest rate,
- Amount of debt,
- Use of borrowed funds,
- Maturity dates of debt,
- Lines of credit,
- Current loan restrictions, i.e. any collateral requirements, and
- Other liabilities, i.e. severance payments, earned but unused vacation time.

Long-term debt to total unrestricted fund balance (net worth) is a key indicator of a non-profit's long-term credit obligations and its ability to repay them. If the long-term debt to total unrestricted fund balance ratio exceeds 1, then additional debt may not be advisable.

Cash Flow Projections

This amounts to profiling what will be the cash generated by the net operating results of the activity and comparing it to future debt service requirements. Do the projected cash flows cover future debt service payments? Are the projections reasonable? A manager should review not only the projected cash flows of an organization but also examine the method and key assumptions by which they were projected. Does the organization propose to pay future debt payments with future cash flows and, if so, are these flows dependable and adequate? Generally, the manager is looking for debt service that can be covered comfortably under existing revenues or from moderate increases in revenues net of realistic increases in expenses.

Additional Factors

1. *Financial flexibility.* How much of the non-profit's assets are in restricted funds or endowments? The greater flexibility an organization has in the use of its net assets, the better it can respond to unexpected financial adversity.
2. *Pending litigation.* Lawsuits against the organization must be disclosed. Pending litigation, especially where it appears the non-profit will lose, is a negative.
3. *Fund-raising ability.* The organization's fund-raising ability and track record illustrate their ability to repay current and future debt. A healthy organization should have predictable revenues and low fundraising costs relative to funds raised.
4. *Insurance.* Does the non-profit have adequate insurance? This is especially important if there is physical collateral, such as real property pledged as security.

5. *Independent auditor.* Are the financial statements of the organization audited by an independent auditor? Does the audit take any exceptions in its opinion or otherwise place limits on its scope? Are the full financial statements including any management letter and footnotes available?
6. *Financial statements.* Do the financial statements conform to the generally accepted accounting principles and the financial accounting standards board (FASB)?
7. *Banking relationships and credit experience.* Does the group have a good banking relationship and does it have a track record for undertaking liabilities?

HOMEOWNERS ASSOCIATIONS⁵

Homeowner associations are typically not-for-profit entities that are created in residential areas to provide certain services that are used in common, such as upkeep of the grounds, security, and sometimes water and sewer. Their legal status can range from loosely knit, informal co-operatives to formal not-for-profit associations that have regular levies on their members. In some states, the status of fees and charges has risen to that of local taxes when they are collected for “governmental” type services.

Every homeowners association is different and should be evaluated on a case by case basis. In the case of these types of associations, it has been suggested that ten factors should be evaluated in determining credit quality. These are:⁶

1. *History.* The history of the association includes when the association was formed, if it incorporated, and its history of financial success. Other factors include pending lawsuits and the “political” stability, such as recall efforts.
2. *Authority.* It is important to determine whether the association has the power to make levies and if it has the right to borrow, as well as what entity can bind the association, i.e. the board of directors.
3. *Size.* The larger the association, the greater the number of units over which to spread borrowing costs. Associations with fewer than 20 units should be reviewed carefully to

⁵ Source: Oregon Economic Development Department, Safe Drinking Water Revolving Loan Fund, Appendix D, and California Association of Homeowners Associations Inc.

decide if they have the depth necessary to repay future debt. For the very small association, personal guarantees might be considered.

4. *Revenues.* The current and projected revenues (dues, fees, and other charges) must be analyzed to determine if they can cover future loan payments as well as fund operation, maintenance and reserves.
5. *Collections.* There should be formal collection procedures for delinquent dues or fees.
6. *Assessments.* The structure of the association's assessments is important, i.e. how many members are delinquent, for how much and how long. Financing an association where over 10 percent of the members are in delinquency may be problematic.
7. *Records.* All records should match up, i.e. financial statements and the association's bank statements.
8. *Management.* The quality of the association's management needs to be assessed. If the association is self-managed, what is the makeup of the board of directors? If the association is professionally managed, what is the manager's or the management company's background and track record.
9. *Required documents.* The association should submit the last three year's financial reports along with the current budget. These documents should be reviewed for liquidity, solvency, and trends demonstrating the organization's future ability to repay debt.
10. *Insurance.* The type and amount of insurance that an association possesses is important to the financial health of the organization. General liability insurance may be necessary if property, such as playgrounds, is owned. Other forms and types of insurance may be necessary depending on location and activities.

INDIVIDUALS, HOMEOWNERS, AND FARMERS

Individuals and farmers are economic entities with income and assets and follow the same basic concepts as other borrowers. A financial analysis needs to be completed to determine two things:

⁶ The following factors for evaluating homeowner associations draw heavily from Oregon's Economic Development Department's Program Guidelines and Applicant's Handbook for Safe Drinking Water Revolving Loan Fund.

(1) if an individual has enough cash flow to pay for future debt payments or,

(2) if, in the event of default, sufficient assets to meet the obligation.

As a first step, an individual's balance sheet of existing assets and liabilities and tax returns will be the basic building blocks in evaluating their creditworthiness.

Credit History⁷

The credit history of the individual seeking a loan needs to be reviewed. An applicant's credit history does not have to be perfect to demonstrate an ability and willingness to pay obligations. If unacceptable credit is indicated on a credit report the credit problem should be researched to determine accuracy, since mistakes in credit reporting are made. The following indicators of unacceptable credit are based on the USDA rural development regulations field office handbook.

- No credit history. A lack of credit history is problematic because it becomes difficult to determine an individual's ability and willingness to repay debt and obligations. If no history is reported on a credit report, an applicant may be able to submit documentation to prove an acceptable credit history. Possible documentation includes third party verification, copies of canceled checks, and documentation for other monthly payments, i.e. rent, utilities, phone bills.
- Greater than two debt payments greater than 30 days late within the past 12 months.
- A foreclosure completed within the last 36 months.
- An outstanding tax lien with no acceptable payment arrangement.
- Two or more rent payments paid 30 or more days late within the last two years. (If no other credit problems exist, it may only be necessary to review the previous year's rent history)
- A court-created or court-affirmed obligation or judgment caused by nonpayment that is or has been outstanding within the last twelve months.

⁷ The indicators of unacceptable credit history are from the USDA Rural Development Regulations Field Office Handbook.

The key point to be stressed is the applicant's ability to document a consistent track record of meeting payment obligations.

Income

An income definition must be determined. Whose income is going to be counted? A reasonable approach is to consider only income of the parties legally responsible to repay the loan. Key questions that should be asked include:

- What is the individual's income from wages?
- Is the income seasonal? Is historical information necessary to estimate yearly income?
- Is this individual likely to keep his or her current job and wages?
- What other sources of income does this individual have?

Assets

What types and amounts of assets does the individual possess? Assets that should be reviewed include:

- Checking and savings accounts.
- Stocks, bonds, saving certificates, money market funds, other investment accounts.
- Equity in real property or other capital investments.
- Trust funds.
- Lump sum receipts, such as inheritances and capital gains.
- Personal property (such as jewelry) held as an investment.
- Cash value of life insurance policies.
- Retirement assets.

When valuing assets, the relative liquidity (ability to convert into cash) and any restrictions on liquidations are important factors to consider. Cash and securities that are near maturity or easily converted into cash are worth more as security than land, personal property, and retirement funds.

Liabilities

The liabilities, which an individual has, must be disclosed. The ability of an individual to make loan payments is a factor of income less liabilities. The greater the amount of monthly payments an applicant is responsible for, the less likely they will be to make future debt

payments. A healthy income to debt ratio is .33 or higher. An income to debt ratio below .25 is problematic. Key obligations include:

- Loan payments,
- Mortgage payments or rent,
- Credit card balances/payments,
- Utilities,
- Dependent care, child support and alimony,
- Medical bills,
- Insurance premiums,
- Taxes, and
- Dues.

Other Factors

Lien on wages Are there any liens on future wages?

Pending litigation Does the individual have a litigation pending that would effect their financial condition?

Insurance Does the individual seeking a loan have an adequate life insurance policy?

Non-related Business Does the individual have a 10% or more interest in other businesses?

PRIVATE FIRMS AND COMMERCIAL FARMERS⁸

Private firms and commercial agriculture can be nontraditional borrowers. If the loan is a substantial amount and based on commercial activity, credit analysis may be complex. The manager may want to hire outside experts to help (See PENNVEST). Character and capital are the two major areas that are analyzed when determining the creditworthiness of private firms and farmers. The character of the organization is determined by looking at the honesty, integrity, management ability, and track record of the applicant. Receiving credit reports of the firm and the principals of the firm may help in determining the character of the organization. Credit reports of the firm can be ordered from Dunn & Bradstreet (800-234-3867). Credit reports of individuals can be ordered from Equifax (800-879-1025).

⁸ Source: Oregon, Appendix D

An in-depth look at a firm's liquidity, solvency, and financial trends will illustrate the firm's ability to borrow and withstand financial adversity. Copies of the last three years' financial statements and income tax returns are necessary to conduct this analysis. Four key points to look for include⁹:

- Do the financial statement include balance sheets, income statements, and statements of cash flows?
- Do the financial statements conform to the generally accepted accounting principles and the financial accounting standards board (FASB)?
- Are the financials prepared by a CPA? Do they need to be reviewed by a CPA?
- Credit history of anyone owning more than 10% of the firm?
- Has the borrower produced positive "cash provided by operations" in two of the last three years? A good general rule is not to finance borrowers who do not pass this test, except when the proposed project will cure the weak performance.

Financial Ratios

A comparative analysis of key financial ratios should be performed. Each borrower should be compared to other firms in the same industry. Comparative information can be received from Robert Morris and associates (RMA) annual statement studies. This information can be accessed and purchased off of their web site "www.rmahq.org". Each industry has a separate standard industrial classification (SIC) code. Some relevant SIC codes are:

Water companies	SIC # 4941
Agriculture-wheat	0111
Farms-dairy	0241
Eggs-chicken	0252
Motels, hotel, & tourist courts	7011

RMA reports the ratios broken down into four groups of equal size. A strong firm will be in the upper or middle quartiles for the majority of the below ratios. Lending to private corporations and farmers that do not meet these criteria may be risky. A possible exception is when the proposed project will cure weak performance in the ratio analysis.

⁹ Source: Oregon, Appendix D

RMA presents the ratios in five categories: liquidity, coverage, leverage, operating, and expense to sales. Some industries, such as agriculture, are reported without expense of sales figures. The following are ratios that RMA reports on, which can be used in analyzing the financial capabilities of a firm.

Liquidity ratios. These ratio help measure the quality and capacity and current assets to meet current obligations.

- Current ratio
- Quick ratio
- $\frac{\text{Sales}}{\text{Receivables}}$
- Day's receivables
- $\frac{\text{Costs of Sales}}{\text{Inventory}}$
- Days' Inventory
- $\frac{\text{Cost of Sales}}{\text{Payables}}$
- Days' payables
- $\frac{\text{Sales}}{\text{Working Capital}}$

Coverage ratios. These ratios attempt to measure a firm's ability to pay for debt service.

- $\frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest and Principal}}$
- $\frac{\text{Net profit} + \text{Depreciation, Depletion, Amortization}}{\text{Current Maturities Long-term Debt}}$

Leverage ratios. Leverage ratios show the indebtedness of the firm relative to net worth. Firms that are highly leveraged are more vulnerable to economic downturns. It should be noted that leverage ratios vary greatly depending the requirements of particular industries.

- $\frac{\text{Fixed}}{\text{Net Worth}}$
- $\frac{\text{Debt}}{\text{Total Assets}}$

Operating ratios. These ratios help in the evaluation of management performance.

- $\frac{\text{Profits before Taxes}}{\text{Tangible Net Worth}}$

- Profits before Taxes
Total Assets

- Sales
Total Assets

Expense to sales ratios. These ratios show specific expense to net sales and are usually expressed as percentages.

- Depreciation, Depletion, Amortization
Sales
- Officers', Directors', Owners' Compensation
Sales

PENNVEST

The State of Pennsylvania has formed the Pennsylvania Infrastructure Investment Authority- or “PENNVEST”- to help fund infrastructure improvements. PENNVEST contracts with a CPA firm to conduct the credit analysis necessary to make infrastructure loans. Analysis includes:

A balance sheet and income statement review-a multiyear revenue and expenditures analysis.

Cash flow versus debt service analysis. This review examines the existing debt and projected debt against revenue projections of the borrower. This establishes any potential rate increase needed for the water companies.

Relative risk assignment. Codes assigned are speculative (credit concerns), concern speculative users (new home development or business development), concern high rate (implementation of new service rate), and not speculative (healthy financial position).

The analysis is conducted and an applicant is determined to either have or lack financial capability. Also reviewed are general collateral considerations of a potential borrower: liens on revenues, rate increases, guarantees of owners, liens on company real estate (equipment). Reasons why a firm may be denied funding include¹⁰:

The borrower and, or its parent company, has declared bankruptcy which has not yet been discharged.

The borrower or related party is currently delinquent with respect to one or more outstanding Pennvest loans.

The borrower does not have any reliable recurring revenue source from which to fund the repayment of the loan, and other satisfactory collateral is not available.

The borrower does not have adequate or reliable financial information on which to evaluate financial capability.

The borrower has sustained large net deficits, negative cash flow and declining revenues over the last three years, which can not reasonably be expected to reverse as a result of the proposed project.

¹⁰ Reasons for being denied funding are from PENNVEST’s Financial Capability Finding document.

FINANCIAL ENHANCEMENTS AND INSTITUTIONS

Types of Enhancements

Often, either lenders or borrowers will find it is to their benefit to have a third party provide a credit enhancement that, in one form or another, guarantees the borrower's debt service payments under the loan. The SRF may require that the borrower obtain an enhancement as a condition to the loan.

Enhancements may be provided either by a public entity or a private one. In the case of private enhancements, they usually are provided by a financial institution, although private corporations or other institutions may provide such a pledge of added security. The most common type of enhancement encountered is a "letter of credit" from a commercial bank or some other form of depository institution. Another form is an insurance policy written in the favor of the investor or lender that guarantees timely payment of debt. The latter form of enhancement, known as bond insurance, has become very common in the bond market.

The principles for analyzing the creditworthiness and value of such a pledge of "substitute" security are much the same as has been discussed above.

1. Make sure that the guarantor is financially sound.
2. Make sure that the enhancement is irrevocable for the period under consideration, subject to reinstatement if used (drawn upon), and is in force throughout the life of the loan.¹¹
3. Make sure that if the credit enhancer suffers any significant deterioration in credit quality, a suitable replacement for the enhancement is procured.
4. Make sure that the enhancement is exclusively for the benefit of the lender (direct pay) and not subject to legal interference or offset by the enhancer against other debts of the borrower.

Credit Quality of the Financial Institution

The easiest and most likely the best way to be assured of the financial institution's creditworthiness is to receive a copy of its rating. Virtually all financial institutions have some type of rating. These ratings may be from the major rating agencies (Moody's, Standard and Poor's, Fitch IBCA) or, in the case of commercial banks and savings institutions, from the

¹¹The lender should have a copy of the letter of credit and the reimbursement agreement with the bank.

specialized sector rating agencies including Scheshenoff or Thompson's Bank Watch. If the enhancement is provided by an insurance company, these companies are rated by Best & Company. Each has its own symbols or numeric scoring system to connote credit quality.

Sometimes there will be more than one rating published for a company and the ratings may refer to different aspects of its business. The rating that a manager is most interested in is that of "claims paying" ability; the relative ability of the enhancer to make good on its "guarantee" to either pay off the debt or to step in and pay debt service. It is not unusual for securities firms, for example, to have subsidiaries that have better credit ratings of their claims paying ability than the parent corporation has on its own indebtedness due to the subsidiaries relatively stronger and use-restricted capitalization.

Other Indicators of Bank and Institutional Condition

Although not formally a "rating," the opinion of the bank and savings institution regulators is an important source of information on financial condition and the adequacy of capital. Financial institution regulations break down institutions into five categories, with the top two being "well capitalized" and "adequately capitalized." To be "well capitalized" an institution must meet such capitalization tests. Information regarding the classification is revealed in the institution's annual financial report.

Generally, an enhancement provider should be classified as "well capitalized" and should be subject to replacement by the borrower as a provider if it loses this status or if its rating is reduced. The rule of thumb on the value of enhancements is that the enhancer should carry a higher rating than the party being enhanced.

Three case studies illustrating, under hypothetical lending situations, the application of the analytical tools described above can be found in the appendix.

APPENDIX

CASE STUDIES

Introduction

Credit analysis is not cut and dried especially when it comes to non-traditional borrowers. The following three case studies are meant to illustrate many of the “principles” discussed above. Credit analysis is done on a case-by-case basis. There may be more (or less) to the applicant’s resources than initially meets the eye in the application of these principles.

The credit manager is involved in a due diligence in which he or she starts with the proposed project, the financial statements and related credit documentation, and the borrower (“*the story*”). The manger must then ask “*key questions*” about the borrower’s track record and future ability to repay the debt under a range of conditions. The answer to these questions decides if the loan will be made or not and if so, under what conditions, which is the “*outcome*” of the application process.

Farmer Jones

The Story

Tables 1a and 1b and Table 2 respectively represent a simplified balance sheet and income statement for Farmer and Mrs. Jones. He wishes to put in improvements that will help control run off from his agricultural operation. He is not under a court order or an enforcement action. But, he is worried that if he does not make the improvements, he may be liable for fines and restrictions on his operations.

If Farmer Jones makes the improvement, he will receive a total abatement in his property taxes from the County for 10 years. These taxes currently run \$1,000 a year. The project will cost \$20,000, of which a local bank has agreed to lend half the needed amount at an annual rate of 8 percent, payable in 5 years. (The bank already holds a note for \$10,000 for earlier improvements to the farmhouse.) There is also \$10,000 left on a mortgage that requires \$1,500 in debt service per year. Jones would like an SRF loan for the remaining \$10,000 and would prefer to pay interest only for five years with amortization of the principal to start when the bank loan is paid off.

The balance sheet and income statements are adjusted to reflect how they will look *after* the improvement is made and were the loan to be made. Improving waste handling is estimated to save the farmer operating costs of \$1,000. The SRF loan with interest-only for the first five years at an interest rate of 3 percent would add \$300 a year to the debt service for the first five years and then jump to about \$2300, declining to about \$2000 for each year, starting in year six.

The note to another party on the balance sheet is investigated and it is discovered that it is owed to a relative that is willing to take a subordinated position.

Key Questions

What is Farmer Jones' credit history?

Jones' credit report is fairly clean. He made one late debt payment three years ago. This does not materially affect Jones' credit history. He appears to have a consistent track record of ability and willingness to pay obligations and has had a long-standing banking relationship.

What is Farmer Jones' income?

Referring to Table 1B it is shown that Net Farm Income is \$27,000. Mrs. Jones works at the local day care center making \$25,000 a year. Asset income totals \$4,000. Since both Mr. and Mrs. Jones' name will be on the loan their combined yearly income of \$56,000 is considered for the loan.

Farming has its risks and cycles, but Jones has averaged \$25,000 to \$35,000 net income the last five years and has a very stable record.

What assets does the Jones family possess?

Table 2 shows us that total assets equal \$180,000. Some \$50,000 of that represents \$10,000 in cash and \$40,000 in financial assets, of which \$20,000 is liquid investments (the additional \$20,000 retirement savings are subject to penalty if withdrawn). Jones carries homeowners insurance and crop insurance.

What liabilities would the Jones's family have?

Table 2 shows the Jones' balance sheet with the SRF loan. They would owe \$20,000 to the bank, \$10,000 from a previously loan and \$10,000 for the run off improvements. Mr. Jones owes \$40,000 to his brother, a wealthy businessman. Businessman Jones is happy to take a subordinate loan repayment position and take 6 percent interest only during the period of the SRF loan (\$2,400 in annual debt service). Other liabilities include Accounts Payable of \$5,000 and annual mortgage payments of \$2,500. The proposed SRF loan is shown as \$10,000.

What other factors need to be considered?

This loan and subsequent improvements will change Farmer Jones' financial situation. Jones would be receiving a tax abatement of \$1,000 per year from the county. Also, Jones operating costs will be lowered by \$1,000 a year. These two changes materially affect Jones financial prospects and should be included in the financial analysis. To the degree the tax reduction and operating costs are realized, they should add approximately \$10,000 in value to the farm as an enterprise. This is figured by dividing the annual savings by a capitalization rate. In this case we settle for an "eye-ball" estimate of \$10,000.

Table 1A: Jones' Income Statement without Loan and Improvements

Gross Farm Money income	126,000	
Operating costs	<u>100,000</u>	
Net farm Income		26,000
Outside wage income		25,000
Asset income		<u>4,000</u>
Total net income		55,000
Debt service		6,400
Taxes		<u>5,000</u>
Net cash		43,600

Table 1B: Jones' Income Statement with Loan and Improvements

Gross Farm Money income	126,000	
Operating costs	<u>99,000</u>	
Net farm Income		27,000
Outside wage income		25,000
Asset income		<u>4,000</u>
Total net income		56,000
Debt service		9,200
Taxes		<u>4,000</u>
Net cash		42,800

Table 2: Jones Balance Sheet (with SRF loans)

<i>Assets</i>		<i>Liabilities</i>	
Cash	10,000	Notes to Bank	20,000
Financial Assets	40,000 ¹	Notes to Others	40,000
Supplies	5,000	Accounts Payable	5,000
Equipment	25,000	Mortgage	10,000
Land Value	100,000	SRF Loan	<u>10,000</u>
		Net Worth	95,000
Total	180,000	Total	180,000

Table 3: Debt Service Payments (with SRF loans)

Years	To Bank (both loans) +Mortgage	SRF Loan	Loan from Businessman Jones	Total Debt Payments
1	\$6,500	\$ 300	\$2,400	\$9,200
2	6,500	300	2,400	9,200
3	6,500	300	2,400	9,200
4	6,500	300	2,400	9,200
5	6,500	300	2,400	9,200
6	4,000	2,300	2,400	8,700
7	4,000	2,300	2,400	8,700
8	4,000	2,300	2,400	8,700
9	4,000	2,300	2,400	8,700
10	4,000	2,300	2,400	8,700

Summary

Reviewing Farmer Jones's debt service schedule it is seen that Farmer Jones has adequate debt service coverage. The total of \$9,200 annual payment is not excessive compared to the \$56,000 annual income, since at that income level a debt service at 25 percent or less of income is not excessive. The nature of Jones' farming is such that he has stable revenues. Jones' income and cumulative net worth is adequate to make debt payments.

Jones' current assets include \$50,000 in cash and financial assets and \$5,000 in supplies. Some \$25,000 of these assets is cash or easily converted to cash. His current liabilities consist of \$5,000 on accounts payable and debt payments due each year of \$9,200 assuming that the SRF loan is for "interest only" for 5 years until the bank loan portion is paid and then is "level debt service" for 5 years.

Jones' current ratio (current assets to current liabilities) is $\$25,000/\$14,200 = 1.8$. Jones' quick ratio (cash equivalent assets to current liabilities) requires subtracting out the retirement assets and supplies from current assets. It is calculated at $(15,000/14,200) = 1.1$

Although the bank loans and the mortgage are secured on the land and equipment, the total debt is \$30,000 versus the conservative market value of \$100,000 for the land alone at current value or \$110,000, if we allow for the increased value due to better operations and reduced taxes. The equipment is relatively new and sufficient to work the farm and the \$25,000 value could likely be recovered. Thus, the Jones net worth appears to be a solid \$95,000 to \$105,000.

Lake Harry Homeowners Association

The Story

The Lake Harry Homeowners Association is made up of seasonal residents that have homes on or near Lake Harry. These 50 homes are on septic systems that are now polluting the lake. The county is under orders to take steps to correct the situation and will allow no more new construction of homes or improvements to current buildings until the problem is solved. The homes also face either condemnation or a mandatory clean-up effort if improvements are not made immediately.

A systematic improvement to the septic system will cost an average of \$10,000 (\$7,500 to \$15,000 per residence) or a total of \$500,000 for association members. There are considerable economies of scale if all properties are improved at once. If improvements are done one at a time, the cost will be one-third higher. The homeowners association, a non-profit, would like to be the recipient of the loan from the SRF. It would make the improvements on behalf of the homeowners, with a first or second mortgage on the properties. The state court has ruled that homeowner dues to associations for public necessity improvements are tantamount to tax liens on property and come before other creditors.

The association would like a 10-year loan from the SRF with level payments of the debt service. At a 5 percent loan rate, this amounts to annual debt service of \$140,000 per year or \$2,400 on average per home. Current association fees are \$1,000 per residence per year. The association, in addition to common area holdings, has the development rights to land that could support an additional 20 homes. However, the existing landowners do not want the sites developed in order to preserve views and the land could not be developed unless the septic problem is solved.

A local real estate appraiser has estimated that the market value per residence is \$50,000 and is subject to decline if the conditions are not improved. With the septic system improvements, home values may rise, even with the threat of higher homeowner fees. The appraiser also believes that the development rights (carried at an original purchase price of \$100,000) if used on new homes would be worth \$15,000 per site, or \$300,000, if the septic system were improved. The land on which the rights are held currently derives \$1,000 revenues from a hunters club. Financial investments of the association of \$20,000 earn another \$1,000.

Key Questions

Can the Homeowners Association raise dues?

The Association has the ability to raise dues but only with the approval of the homeowners. To raise dues two thirds of the member must approve the raise. As it currently stands, the Association has not voted to raise dues and there is significant opposition to a raise.

Is there a formal collection procedure for delinquent dues?

Currently \$4,000, 8 percent of yearly dues, are in arrears. Although a formal collection procedure is not in place, the Association is looking into implementing one. As noted, there appears to be what is equal to a tax lien status for the dues when they are used for essential government-type services.

What is the size of the Association?

It is small. Currently the Association has 50 members with the possibility of adding an additional 20 if the undeveloped properties are developed.

What is the Association's annual income?

Annual income is sufficient to pay for normal operating costs but not debt service. Table 1 shows the organization's income statement *with the SRF loan*. Dues must be raised by at least \$135,000 annually to cover the debt service so that the organization can continue existing services and repay the debt. Also an issue is the cost of maintaining the improved septic system. No cost has been formally calculated, but it might be \$25,000 a year or \$500 per unit. A \$165,000 total budget would amount to an average annual dues of over \$3,000 per household, which is three time the existing county property tax. The association has a strong legal power to levy dues, which would be equivalent of local property taxes. However, the capitalized value of the future dues might depress housing prices.

What is its asset position?

The association has only the land rights to develop the added 20 properties but several homeowners oppose that because they would lose views and it would change the

character of the place. However, without the improvements to septic systems no new building can take place.

Table 2 shows the Balance sheet with the SRF loan assuming the SRF loan. It shows that the Association now has a net worth of \$134,000. For accounting purposes, the SRF loan needs to be offset. It shows the future dues collection for the improvement as an offset to the liability to the SRF. As indicated the economic ability of the homeowners to pay dues is questionable. Moreover, the question of “owning” the septic improvements is cloudy since the improvements are on members’ individual properties.

Table 1: Income Statement

Association Dues	\$50,000
Less delinquent	(4,000)
Net Dues	46,000
Earnings in assets	1,000
Other income (Hunt Club)	<u>1,000</u>
Total	48,000
Operating Expenses	43,000
Net Income before SRF	5,000
<i>Debt Service (SRF)</i>	<u>140,000</u>
<i>Net income after loan</i>	(135,000)
<i>Maintaining Septic?</i>	25,000
<i>Net Income</i>	(160,000)

Table 2: Balance Sheet

<i>Assets</i>		<i>Liabilities</i>	
Cash	2,000	<i>Notes to SRF</i>	500,000
Financial Assets	20,000	Accounts Payable	5,000
Supplies	2,000		
Equipment	5,000		
Land Rights	100,000		
Dues uncollected	10,000		
<i>Due from members</i>	<u>500,000</u>	Net Worth	<u>134,000</u>
Total	639,000	Total	639,000

Summary

As it stands, the SRF loan manager would reject the homeowners association's request for a loan as too risky. Key points need to be addressed before a loan would be approved. Dues must be raised substantially to pay for the loan and to provide for likely maintenance costs. Also, the amount of the new debt per unit (\$7,500 to \$15,000) is large in comparison to the housing prices (\$50,000) on average. The homeowners are not interested in developing the additional land, but a majority would likely be willing to pledge the land as collateral to the loan. A firm commitment to make improvements is needed and a legal arrangement between the Association and the homeowners needs to be solidified about the ownership and on-going maintenance of the septic field improvements.

A possible solution could include the addition of a bank letter of credit to secure the loan. The local bank would agree to provide a letter of credit for the debt service payments secured by a first claim pledge on all dues raised by the association. Given the high level of debt a bank under most circumstances would not be willing to provide a letter of credit. But since the bank is heavily invested in the existing mortgages at the Lake, it has an interest in preserving use of the homes and land values; they might find it in their interest to extend credit in this circumstance. It is also comfortable with the tax nature of the association dues and its ability to foreclose on non-dues paying properties.

The bank wants a \$10,000 fee plus a 1.25 percent annual fee for the letter of credit, based on outstanding principal. It is rated A or equivalent by the bank credit rating agencies and is considered "well capitalized" by the bank regulatory agencies. A letter of credit would enable the loan to be secured and development on the septic system to begin. The bank believes it is in its best interest to see the SRF loan approved, because it has an interest in the area's property values.

Another possibility is to form a special district government that would clarify the district's legal position. The County, however, is leery of the small district and assuming any formal liability for it.

Rock Ribbed Land Foundation

The Story

The Rock Ribbed foundation is a non-profit foundation devoted to protecting the environment. It has been in existence for ten years and has substantial land holdings. It is interested in acquiring 2,500 acres of critical watershed land (“Up-water”) to protect against its further development. The environmentally sensitive headwaters are now threatened by tourist-oriented development and mining operations that may move into the area. Purchase of the area will cost \$ 5 million. The foundation already has \$2.5 million in firm written special pledges that will be delivered as soon as the Foundation raises the remaining \$2.5 million. It wants a loan to complete the deal. It will repay the loan when it collects the remainder in multi-year pledges and, if necessary, sells some smaller, less vital parcels. The term of the loan would be 5 years at 5 percent with the \$2.5 million due at the term of the loan to accommodate the orderly sale of surplus land and collection of contributions. The land would be restricted to conservation purposes.

Table 1: Income Statement

Income:	
Program fees	100,000
Annual pledges	250,000
grants	100,000
earnings on assets	<u>50,000</u>
Total	500,000
Operating Expenses	<u>250,000</u>
Interest	50,000
Net Available after operation,	
Contributions to equity	200,000
Less SRF loan DS	<u>125,000</u>

Table 2: Balance Sheet

Assets:		Liabilities:	
Cash	25,000	Accounts payable	25,000
Financial assets (unrestricted)	200,000	Land Notes (5 percent)	1,000,000
Financial Assets (restricted)	800,000		
Annual Pledges Due	100,000		
Special pledges	2,500,000		
Land holdings & Bldg.	<u>2,500,000</u>	Net Worth	<u>5,100,000</u>
	6,125,000		6,125,000

Key Questions

How do Annual Income and Expenses Perform?

The Foundation is able to meet its operating expenses out of programs and grants and the annual dues are almost wholly used to acquire land. This policy has existed for five years and the foundation has always run a surplus. The annual dues have on average a 90 percent collection record. Dues pledged but not yet collected are shown as an asset after discounting for 10 percent non-payment experience. Most members are wealthy persons and corporations and dues solicitation and collection are a relatively minor cost (10 percent of actual collections for dues, or \$25,000 a year).

How secure are the pledges for purchase of “Upwater”?

The \$2.5 million in special pledges is by two large corporations and three other institutions and will be due immediately when the deal closes. The remaining \$2.5 million gap is to be closed by future fund raising for the property. The Foundation has verbal, but not written, commitments for another \$1 million. If this added funding effort is not successful, the foundation has committed to close the gap by selling other unencumbered properties, worth \$1.5 million according to recent appraisals.

How strong is the balance sheet?

The foundation’s balance sheet is very strong. It’s only major liability is 5 percent perpetual land notes for \$1 million that are “interest only” for 30 years. In addition to the unencumbered property worth \$1.5 million (including a fully depreciated

donated building worth \$100,000), it also has \$800,000 in unrestricted financial assets. In addition, the SRF loan would be fully secured by a mortgage of the to-be-acquired Up-waters property, which has a market value of \$2.5 million even when subject to the conservation restrictions. Thus the foundation has adequate assets to secure the loan even were future fund raising totally unsuccessful.

Are there any Operating or Legal Risks?

The investment is totally passive: the acquired land will be unused and, therefore, there are no operating costs or operational risks to consider in the purchase.

Summary

Paying the five-year SRF term loan at 5 percent would have a modest impact on the foundation's income statement and cash flows. The foundation has agreed to restrict and pledge all the special pledges coming in for the purchase of Up-water, as well as subordinate any future debt until the SRF loan is paid. The loan also has a mortgage on the Up-water property.

The land investment is passive, with no operating costs, operational risks, or regulatory problems. Moreover, the foundation currently has good net income and a good track record for financial operations that run a positive result. In view of the strong security that can be pledged by the foundation in the form of a mortgage on the property to be acquired and the other liquid and real assets of the foundation, the loan is approved.

LIST OF STATE PROGRAMS AND CONTACTS

State Program Contacts for Nonpoint Source Lending:

California	Paul Roggensack Associate Water Resources Control Engineer Division of Water Quality State Water Resources Control Board P.O. Box 944213 Sacramento, CA 94244-2130 (916) 657-0673
Delaware	Alan Farling Project and Loan Administration Division of Water Resources Department of Natural Resources and Environmental Control 5 E. Reed St. Dover, DE 19901 (302) 739-5081
Minnesota	Vickie Krech Senior Loan Officer Minnesota Clean Water Partnership Minnesota Pollution Control Agency 520 Lafayette Rd. St. Paul, MN 55155-4194 (651) 296-3630 Bob Ahlin Portfolio Manager Department of Trade & Economic Development 500 Metro Sq. St. Paul, MN 55101-2146 (612) 296-6858
Missouri	Steve Townley Chief, Financial Services Section Water Pollution Control Program Department of Natural Resources P.O. Box 176 Jefferson City, MO 65102-0176 (573) 751-1192
New York	Robert Davis Director, Engineering & Program Management New York State Environmental Facilities Corporation 50 Wolf Rd., Room 547 Albany, NY 12205 (518) 457-9148

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About the Monograph

The design and research for this project was conceived and conducted by **CIFA** staff with the guidance and advice of the project advisory group. CIFA's Executive Director, **James N. Smith** and Management Associate, **Tara Powers** are principally responsible for the overall project and preparation of the text in Part I of the Monograph. The **Government Finance Group**, a financial advisory and research consulting firm, headed by **John Petersen**, a recognized expert in public finance, with assistance from **Suzanne Piotrowski**, prepared the Credit Analysis in Part II and the working examples of hypothetical credit assessment, included in the Appendix.