

**MORTGAGEE RESPONSIBILITY FOR THE CREDIT EVALUATION OF THE
NONPROFIT BORROWER**

The analysis of the nonprofit agency's *management ability and financial capacity* to encumber properties using FHA mortgage insurance is performed by the mortgagee providing financing. The mortgagee must be able to conclude that the nonprofit agency will be able to support the mortgages for which it has applied and that it has the management resources available to administer the affordable housing program. This is particularly important with those nonprofit agencies that have embarked on large-scale programs while having only limited financial capacity or experience. Project sponsorship and management must be in keeping with the capabilities of the nonprofit agency. In making this determination, a number of elements, as described below, will be evaluated.

Program Administration. The lender must examine the track record of the nonprofit agency in developing/managing affordable housing and determine that the nonprofit agency demonstrate the skills and experience needed for the project being proposed. It must consider whether the project consists of lease-to-own properties or long-term rentals, as well as the market absorption on projects the nonprofit agency has completed. Further, beneficiaries of the affordable housing program itself may not be members of its board, employees, or others with an identity-of-interest to the nonprofit agency. Lenders may not approve a situation where such individuals are permitted to purchase or rent housing made available through the nonprofit agency using FHA insured mortgage financing.

Management of the Nonprofit Agency. The nonprofit agency must be able to demonstrate that:

- Its Executive Director and/or key staff have the required experience in developing and administering affordable housing programs;
- It is reliable on the basis of its credit and community oriented reputation and performance or that of its principals and can demonstrate that it understands the responsibilities and obligations, including financial, that attach to sponsorship/operation of a project and its continuing successful operation.
- It is acting on its own behalf and is not under the influence, control, or direction of any outside party seeking to derive profit or gain from the proposed project, such as a landowner, real estate broker, contractor, builder, lender, or consultant. (Lenders are not to provide FHA-insured financing to nonprofit agencies where there is anything less than an arms-length transaction between the nonprofit agency's officers and board members and any individual or corporation, including family members and business partners, that may profit from the program through provision of goods or services. Business relationships must be clearly disclosed. Nonprofit agencies that are *established* by for-profit enterprises must be similarly evaluated.)

Financial Analysis. The financial analysis of a nonprofit agency differs from that of a typical profit-oriented corporation in that it is the stewardship of the funds that is examined rather than profits and worth. The purpose of the financial analysis is to determine that the nonprofit agency has the financial capacity to manage the project and has financial support which will remain during the term of the mortgages.

Most nonprofit agencies utilize a "fund accounting" system. This system provides for the maintenance of separate accounts for funds that are associated with specific activities. Reporting on a fund account basis helps to segregate unrestricted (may be used for most any purpose) from restricted resources (may only be used for a specific purpose).

Performing a financial analysis properly requires the lender to obtain documentation to determine both the nonprofit agency's actual financial capacity and that it has demonstrated stability and proper cash management; these documents are to be included in the case binder submitted to FHA for insurance endorsement. (For relatively large-scale projects where multiple loans will close simultaneously, the HOC and the lender may agree to alternate methods of documentation submission to limit redundant paperwork.) If the underwriter is unsure of any of the terms or entries discussed below, including those on the attached financial analysis worksheet, he or she should contact a CPA for additional information. Please recognize that while the affordable housing program being administered by the nonprofit agency may be approved for a two-year period, the nonprofit agency's financial capacity must be evaluated for each mortgage being considered.

Documentation Requirements

- Form IRS 990, Return of Organization Exempt from Income Tax. This is the tax form filed annually by the nonprofit agency. (Those with a gross income of less than \$25,000 and churches are not required to complete this form but will file an identification portion of the return.) Among other things, Form IRS 990 and supporting schedules include information on the nonprofit agency's income, expenses, assets, liabilities and net assets in the past fiscal year. The lender must obtain the two most recent fiscal year's filings.
- Complete year-end financial statements (balance sheet, statement of activity, statement of cash flow) for most recent two fiscal years prepared in accordance with generally accepted accounting principles and reporting practices and must include the auditor's and treasurer's report and any supplementary schedules. This audit must be in conformance with OMB Circular A- 133 "Audits of Higher Education and Nonprofit Institutions" (if appropriate based on size of the nonprofit agency).
- Most recent 90 day year-to-date financial statement, along with a certification from a CPA or other financial professional attesting that this information accurately represents the financial condition of the nonprofit agency.

- Credit reports on the nonprofit agency itself as well as on the executive director/chief operating official(s) of the nonprofit agency (This is to assure that those in leadership positions with the nonprofit agency exhibit personal responsibilities in managing financial affairs. These individuals will also be matched against CAIVRS and the LDP lists.)
- Corporate resolution delegating signatory authority. (The individual signing the loan application and other documents for the nonprofit agency is not personally obligated on the loan.) and complete articles of incorporation and by-laws of the nonprofit agency.

Funding stream considerations. Much of the analysis of the nonprofit agency's financial capacity revolves around its funding stream. The lender must consider the reliability and duration of the funding stream, and whether the primary sources of funding are competitive, whether the nonprofit agency's funding stream is from a mix of private and public sources, or only from public funds, and if other sources of funding are available should one or more be curtailed. The lender must also consider whether those funding sources permit overhead and administrative allowances as well as the amount of the nonprofit agency's money that will be encumbered by the downpayments on the loans.

Worksheet Analysis. The Department has developed a financial capacity worksheet (page 5) to assist underwriters in evaluating the nonprofit agency's financial condition. Underwriters may use this worksheet or any similar form that captures the same information. The financial statements and Form IRS 990 provide the information necessary to complete this analysis. This data, in addition to the notes to the financial statements, are important in determining current financial strength as well as detecting any negative trends.

In conjunction with the questions below, the lender is responsible for describing how it arrived at the conclusion that the nonprofit agency was an acceptable mortgage risk and met FHA's eligibility criteria. If any of the answers to the questions below are "No," strong compensating factors will be necessary to approve the nonprofit agency as a mortgagor. The analysis must consider the effect of the proposed mortgage debt(s) on the nonprofit agency's financial condition. Nonprofit agencies must disclose any pending mortgage applications, regardless of the type of financing being considered. The lender must also enter the nonprofit agency's federal tax identification number into CHUMS in lieu of a social security number. This will help us track multiple loans to the nonprofit agency as well as track any defaults/claims when reported by the servicing lender into CAIVRS.

From the Balance Sheet

- Based on the number of mortgages being considered, does the nonprofit agency have unrestricted cash balances exclusive of lines of credit and rental income from the financed properties to support a 6 month reserve meeting the *greater of-*
 - a) 10 percent of principal, interest, taxes, and insurance (PITI) payments due each month on all mortgages; or
 - b) total PITI payments for the single largest mortgage?
- Is the current ratio (current assets divided by current liabilities) approximately 2.00 or better? [This liquidity ratio gives an indication of the ability of the nonprofit agency to use its current assets to extinguish its current liabilities. As a rule, the higher the current ratio, the better. This ratio should also be examined as part of the trend for the nonprofit agency. Lines of credit are not to be considered in this ratio.]
- Is total fund balance stable or increasing? [The fund balance is analogous to the equity section found on the balance sheet of a profit-motivated entity and should not be decreasing.]
- Is the percentage of the nonprofit agency's total fund balance to the proposed mortgage debt at least 25%? [This is to determine if the nonprofit agency has sufficient financial size to operate the nonprofit agency and the affordable housing project. Proposed mortgage debt would include any properties not complete and occupied.]

From the Statement of Activity

- Are the support and revenue accounts stable or, preferably, increasing? [Nonprofit agencies with declining support and revenue accounts are unlikely candidates to engage in new affordable housing programs using FHA-insured financing.]
- Is the trend of operating expenses in line with the support and revenue? [As a rule, expenses should not be increasing if support and revenue remain static or are decreasing.]

From the Cash Flow Information

- Have the cash flows from operating activities been positive? [It is the overall trend that is being analyzed, not a discrete point in time.]
- For all FHA transactions involving nonprofit agencies, exclusive of secondary financing programs, lenders must verify that the agency in question is on the approved list. Lenders should use HOC websites to determine a nonprofit agency's ability to participate in FHA programs. If a nonprofit agency does not appear on the approved list, then the lender must contact the HOC for clarification and further guidance.

Suggested Nonprofit Financial Capacity Worksheet

	Current Year	20__	20__
Balance Sheet Information			
1. Cash Balances--(<u>Unrestricted Funds</u>) (Actual cash or equivalents, and short term investments. Inventories and receivables should be excluded from this category. These funds cannot be restricted to any one fund and are considered "liquid.")			
2. Total Cash Balances--Restricted and unrestricted liquid funds			
3. Total Current Assets--Restricted and unrestricted assets that can be converted to cash within one year (e.g. cash and near cash equivalents, accounts receivable, marketable securities, prepaid expenses and inventories).			
4. Total Current Liabilities--Restricted and unrestricted liabilities that must be paid within one year (e.g. accounts and notes payable, income tax payable, and other short-term debt).			
5. Current Ratio (Current Assets divided by Current Liabilities)(line three divided by line four)			
6. Unrestricted Fund Balance			
7. Total Fund Balance			
Statement of Activity			
8. Total Annual Support and Revenue			
9. Total Annual Expenses (Operating Budget)			
Cash Flow Information			
10. Cash Flow from Operating Activities			
11. Total Net Increase or (Decrease) in Cash Also known as an increase/decrease in working capital			