HIGH IMPACT
FINANCIAL ANALYSIS

Enterprise Risk Management for CDFIs

Industry Guidance from High Impact Financial Analysis, LLC

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Introduction

Community Development Financial Institutions ("CDFIs") provide much-needed capital to solve for financing gaps in low- and moderate-income communities across the United States. This role is indispensable in the best of times and becomes even more critical in times of economic uncertainty. Economic crises like the one caused by the COVID-19 pandemic compel traditional financial institutions to reign in credit standards, reduce lending, and avoid perceived risks. This is in part justified by regulatory requirements and recessionary risks. However, it is also symptomatic of a broad-brush approach that systematically punishes our most vulnerable communities. Consequently, as the operating environment becomes riskier, the need for strong, highly functioning CDFIs grows.

For CDFIs to thrive during times of need, proactive enterprise risk management ("ERM") is critical. ERM describes an organization's approach to addressing the high-level, existential threats that, if realized, could substantially impair the organization's ability to fulfill its mission. These include exogenous threats like exposure to lawsuits and uninsured losses, as well as internal threats like failing to maintain sufficient liquidity to meet payment obligations. By addressing the four areas of ERM covered in this paper, CDFIs will inspire confidence in their capital providers and lower their operational risk, allowing them to bravely lend into a troubled economy.

Capital Management

Effective capital management is fundamental to any lending institution and can be a differentiator in performance. CDFIs are no different, constantly balancing loan demand with draws on capital sources to ensure sufficient net interest income margins and adequate liquidity. While CDFIs generally enjoy high renewal rates on the loans and program related investments ("PRIs") that finance their balance sheets, CDFIs must be prepared to repay investments as they mature. This challenge is complicated for CDFIs by the common practice of financing long-term assets (such as real estate loans with 30-year amortizations) with short-term capital (such as a five-year PRI). Monitoring these varied priorities is a complex task in good times, but in a recession, this balancing act carries existential weight.

The practice of ensuring that cash flows from assets (the loan portfolio) are sufficient to repay liabilities (the PRIs and loans that capitalize the portfolio) when due is called asset-liability matching ("ALM"). This is an essential operation for CDFIs—failing to repay an investor can spell the end of an organization, but being too conservative reduces community impact and limits growth. A strong ALM program goes beyond modeling current expectations and instead requires the ability to test different scenarios reflecting upside and downside economic conditions. Such forecasting is not intended to predict the specific scenario that will come to be, but instead informs management what the results of the highest risk scenarios are. If an institution can be comfortable with the outcomes of those scenarios, it can move forward confidently. If the risks in a downside economy are unacceptable, identifying that before the scenario materializes offers time to make the changes necessary to ensure sustainability even in adverse conditions.

How High Impact Can Help

To make the best decisions in stable times and in times of crisis, being able to quickly get accurate forecasts in the hands of management is essential. High Impact's ALM model for CDFIs generates sophisticated cash flow forecasts that can be stressed via customized scenario assumptions. The model incorporates the details of a given CDFI's lending program—the loan portfolio, product mix, and capital sources—to generate monthly cash flow forecasts and analytics on a rolling basis. Our model allows CDFIs to test how changes in refinancing rates, collection assumptions and other variables impact cash flows. Whether modeling short-term forbearance or a worst-case scenario of extended payment delinquencies, High Impact's ALM model provides management with a clear, unfiltered view of risk.

ERM Checklist: Capital Management

- ☑ Develop and maintain asset-liability matching and liquidity policies.
- ☑ Invest in an asset-liability matching model that allows for comprehensive scenario testing.
- ☑ Consider forming an ALM committee to provide board oversight of capital adequacy.

Insuring Operations

Insurance should be a part of every ERM discussion. Common insurance policies held by CDFIs include general liability, commercial property, workers compensation, and directors and officers insurance . While there are many other types of insurances that may be sensible for CDFIs to hold dependent upon their lines of business and means of operation, for the purposes of this paper we will highlight cyber insurance and employment practices liability insurance, two less common policies that are worthy of consideration for CDFI risk managers.

Cyber insurance is growing in importance as CDFIs shift to remote work, increasing reliance on data networks and creating new vulnerabilities. For CDFIs, the most critical risks covered by cyber insurance relate to (1) breaches in data or (2) ransomware or other malware attacks that impede an organization's access to its data. Data breaches, the first risk, are a threat because CDFI servers generally contain sensitive data—tax returns, social security numbers, internally-prepared financial statements, and information on business plans, development projects, and other confidential material. Cyber insurance can protect CDFIs from the costs associated with litigation and other adverse consequences of data breaches. The second risk is especially daunting as CDFIs learn to operate remotely. Ransomware attacks, which can render data encrypted (and as a result, useless) until a ransom is paid, are increasing in frequency and often target organizations that lack the resources for top-tier data protection. Other malware, which can enter networks through phishing emails and other guises, can have similarly damaging consequences. Cyber insurance can offset the costs resulting from these attacks, up to and including paying ransoms—often six figures or more—to restore data.

Employment practices liability insurance ("EPL") is another valuable insurance coverage, though it can be harder to internally recognize the need for such a policy. Especially as mission-focused organizations, it can be easy for CDFIs to feel that their commitment to equity and inclusion will prevent them from facing lawsuits related to hiring, firing, sexual harassment, or other HR-related issues. This can be a costly assumption. CDFIs should investigate the benefits of EPL to make an informed decision of whether or not this is a coverage that is right for them. Some insurance carriers advertise free legal and human resources help to insured parties to help them avoid claims—a clear win-win that effectively buys down the cost of the insurance for the insured and the insurance provider.

ERM Checklist: Insuring Operations

- ☑ Review insurance policies with your management team and insurance professionals to ensure you understand what policies do and do not cover.
- ☑ Consider adding less common coverages, such as employment practices liability insurance or cyber insurance, to decrease your uninsured risk exposure.
- ☑ Maintain strong policies for cyber security and provide training to staff to recognize phishing attacks, properly handle confidential information, and avoid other common cyber security pitfalls.
- ☑ Ensure your employee handbook adequately addresses policies regarding hiring, termination, and nondiscrimination in the workplace, and that those policies are faithfully implemented.

Portfolio Analytics

The loan portfolio is the largest asset for most CDFIs. As such, a deep understanding of the portfolio's performance, risks, and opportunities is critical to ERM. Regularly monitoring portfolio analytics should be the responsibility of multiple parties within a CDFI. The board and staff leadership need to understand the portfolio in order to guide strategy and set effective policy. The Chief Financial Officer should be able to evaluate the impact of portfolio assumptions on expected liquidity and earnings. Lending staff need to ensure that they are producing performing loans that meet targets for profitability. The Portfolio Management team needs to know where to deploy resources to intervene before signs of weakness become full-blown workouts. All of these stakeholders share the broad goals of making better loans and managing the portfolio more effectively, both of which ultimately allow for greater, more sustainable community impact.

A good starting point for any portfolio review is to understand trends in risk rating distributions, delinquencies, and charge-off rates. A dashboard approach, which involves key portfolio performance indicators displayed in an easily digestible visual report, is common to facilitate top-level review. To garner the most meaningful insights from portfolio data, however, requires the ability to dive deeper into areas of interest and compare historic and forecasted performance. This allows for the identification of trends and vulnerabilities that management can proactively address. To facilitate this, CDFIs need to implement a thoughtful approach to data stewardship, which often necessitates collaboration across departments and a commitment to data integration. Investments in coordinated and consistent efforts to improve data tracking and portfolio analytics can produce internal efficiencies and arms management with the data needed to make sound, confident decisions.

How High Impact Can Help

Making portfolio data more accessible is important to balance portfolio monitoring with competing priorities. High Impact's portfolio analytics tool is designed to eliminate the obstacles between CDFIs and effective portfolio analytics. With an easy-to-update interface, CDFIs can quickly pull in data from multiple sources without manual integration, allowing for monthly or quarterly updates in minutes. Customizable dashboards offer high-level statistics, while a user-friendly click-through interface facilitates more detailed analysis on specific topics. Automated reports keep management informed of the most important point-in-time data and historic trends, and can be customized to meet the varied needs of investors, board members, and other stakeholders.

ERM Checklist: Portfolio Analytics

- ☑ Monitor performance frequently and maintain time series data for multiyear and quarter -over-quarter comparisons.
- ☑ Ensure access to portfolio reports for all key stakeholders: board and staff executives, lending staff, finance staff, and portfolio management staff.
- ☑ Invest in systems that allow for quick, efficient access to portfolio data to facilitate data-driven decision making.

Policies and Procedures

Formally documenting company policies and procedures has numerous advantages: it clarifies the company's approach to various functions, allows new employees to quickly become well-versed in organizational practices, and ensures that the organization's values and strategic priorities are reflected in operations. In addition to these very practical, day-to-day benefits, policies and procedures are also a vital ERM tool.

Written policies and procedures provide a framework for how the organization operates and establishes mechanisms for accountability. Codification of best practices ensures there is no excuse for failing to live up to those standards of operations. CDFIs should confirm they have written policies covering core functional areas: lending, fundraising, human resources, and finance. As an organization grows, the scope and scale of its policies and procedures evolve to include greater depth. This is wholly appropriate, but it is critical that even small or emerging organizations ensure the basics are covered. Policies can be written in-house, but third-party expert input is often helpful to ensure compliance with all applicable laws and regulations as well as inclusion of best practices from others in the industry. Involving all levels of the organization in the development of policies and procedures, rather than just management, will ensure that the realities of day-to-day work and the best ideas of all parties are reflected in the finished product.

How High Impact Can Help

Lending policies and procedures are the backbone of a loan program. They describe the objectives of the program, define the loan products and acceptable terms, and detail how loans are made and how the portfolio is managed. High Impact helps CDFIs and other impact lenders write de novo policies and procedures, edit and update existing policies and procedures, or separate the policy document from the procedures manual. Our industry-level perspective helps CDFIs integrate best practices while tailoring the document to their specific needs and context.

Once policies and procedures are in place, they should be reviewed on a regular schedule. This ensures that new technology, changes in the org chart, and new laws and regulations are captured accurately. CDFIs may also want to consider a policies and procedures audit in which a third-party reviews policies and procedures and observes day-to-day activities to confirm they are being implemented as written. This assurance will may uncover gaps and lead to suggestions for improvements and efficiencies. Monitoring and enforcing compliance can prevent legal issues and financial problems, and can also ensure that best practices are being followed. While policies and procedures are often the internal project that gets waitlisted in favor of the pressing external needs of the day, CDFIs need to prioritize their completion and implementation as a component of their risk management strategy.

ERM Checklist: Policies and Procedures

- ☑ Document policies and procedures in each of the core functional areas of the CDFI: lending, fundraising, human resources, and finance.
- ☑ Regularly review policies and procedures and consider hiring a third party to audit compliance with established policies and procedures.
- ☑ Include all staff in the process of creating and reviewing policies and procedures to ensure practicality and secure buy-in.

Conclusion

In their everyday lending activities, CDFIs are accustomed to managing risk, and their track record of low default rates proves that they are excellent risk managers. As we move into more challenging economic conditions, the importance of monitoring and managing high level-risks throughout the organization, and not just in loan originations, increases substantially. Through proactive management, CDFIs can insulate themselves against the myriad risks they face from diverse challenges, including liquidity shortfalls, litigation and criminal activities, operational oversights, and changes in portfolio performance. An effective and comprehensive ERM program can provide staff and board members with the framework they need to carry out the mission of the organization, and it offers funders the confidence needed to continue providing capital in an environment of elevated risk. Effectively managing enterprise-level risks ensures that nothing will stand in the way of CDFIs in this new time of need for the communities they tirelessly serve.

About High Impact

High Impact Financial Analysis is a Certified B Corporation that believes conscious capital and innovative partnerships create thriving communities. We help mission-focused lenders build and maintain high-performing portfolios that support at-risk communities. Our consulting, underwriting, and portfolio management services and tools are trusted by community development financial institutions, government agencies, and foundations nationwide. Since our founding in 2014, we have underwritten over $500 million of community development loans and investments and helped guide the strategy and support the development of lenders ranging from start-up loan funds to the most sophisticated community development lenders in the country.

To learn more, visit us online at www.highimpactanalysis.com or contact us at analysis@highimpactanalysis.com.

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