Community Development Financial Institution (CDFI) Loan Fund Business Model:

The Four Essential Pillars Framework

OPPORTUNITY FINANCE NETWORK®

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Introduction to CDFI Loan Fund Business Model: The Four Essential Pillars Framework

The Four Essential Pillars Framework is a high-level operating roadmap for emerging or existing Community Development Financial Institution (CDFIs) loan funds — serving as a concise, practical guide that covers all the essential parts of a CDFI. Every CDFI has some version of the four pillars:

- Strategy (mission and goals)
- Lending policies and procedures (loan product(s), procedures, loan risk management, etc.)
- Organizational infrastructure (human resources, systems, etc.)
- Financial strategy (cash management, sustainability, risk management)

For organizations new to the CDFI space, it is important to highlight a few key definitions. The CDFI Fund at the U.S. Department of Treasury defines a CDFI as an organization that expands economic opportunity in low-income communities by providing access to financial products and services for local residents and businesses. To become a certified CDFI by the Treasury Department, an organization must meet the following requirements:

- Is a legal entity at the time of certification application
- Has a primary mission of promoting community development
- Is a financing entity
- Primarily serves one or more target markets
- Provides development services in conjunction with its financing activities
- Maintains accountability to its defined target market
- Is a non-government entity and not under the control of any government entity (Tribal governments excluded)

To learn more about CDFI certification, visit www.cdfifund.gov.

The Four Pillars guide summarizes the critical elements of a CDFI business model and — most importantly — gives CDFI managers a framework for thinking about the development of their CDFI and how to prioritize and balance investment in each area to maximize sustainability and impact as their organization grows. The appendices include tools, templates, and other helpful resources.

This guide will link to actionable toolkits for each critical element that will provide in-depth "how to" guidance on specific issues and topics including tools, templates, and sample best practices, as applicable. Together, the framework and toolkits are practical, user-friendly guides for CDFIs at all stages of growth. While they are written specifically for CDFI loan funds, they can be adapted to the other types of CDFIs (banks, credit unions, and venture funds). As of September 2022, two toolkits are currently available on CDFI Connect: The Loan Policy Toolkit and the Cash Management Toolkit. Other toolkits will be forthcoming.

This section provides an outline of the four pillars model and how it applies to CDFIs. The guide then explores each pillar, providing a definition, the reason the pillar matters, components of the pillar, and high-level observations on establishing and managing the pillar. In some cases, "pro tips" are included to support management and implementation decisions.

How Best to Use the Four Essential Pillars Framework

Apply the framework holistically.

The framework is intended as a comprehensive but not exhaustive tool. Each pillar is not only essential for a CDFI's strategic and tactical success, but also provides critical support for the remaining three pillars. For example, a CDFI that does not sufficiently develop and deploy the strategy pillar will quickly run into challenges developing lending policies and financial strategy given the lack of clear strategic direction. Alternatively, a CDFI that spends a bulk of time and effort on the lending policies and procedures and financial strategy pillars without considering organizational infrastructure will become a proverbial boat without an oar, unable to execute on plans without sufficient resources or systems.

The pillars are interdependent, functioning like a Venn diagram. Each pillar has its own domain of needs and priorities along with critical overlapping areas where the pillars mutually support and reinforce each other.

The framework is broad so it can be used for CDFIs of any size or stage.

The CDFI industry is as diverse as the clients it serves. Despite that diversity, there is a foundational framework for structure and management that is essential to high-performing, mission-aligned CDFIs. Conceptually, this framework provides any CDFI — large or small, emerging or long-standing — a complete view of the most critical elements to manage a successful CDFI.

The framework is intended to be a flexible, user-friendly tool that CDFI practitioners can deploy in the ways that meet their needs best. Emerging or early-stage CDFIs may need to invest significant time studying and building out foundational elements of each pillar and can use the accompanying toolkits to help guide and shape that work. Long-standing or large CDFIs may use the framework to strengthen their organization and as a staff training tool for new hires who have not yet worked in the CDFI industry.

Applying the framework is an ongoing process.

The work of CDFIs is, by definition, iterative. CDFIs seek out and fill spaces where easy answers and straight lines are few and far between. The work of strategic management through the Four Essential Pillars Framework model reflects that reality. The framework invites a continuous improvement lens of iteration when adapting to changing conditions, seizing on new opportunities, and responding in times of crisis. The goal of the framework is to support the intentional work of adjusting and honing the effectiveness of any CDFI as it grows, changes, and adapts to the communities it serves. CDFIs can use the framework on an ongoing basis to revisit their strategic alignment as well as tactical execution.

The framework is strengthened by systems of accountability.

The Four Essential Pillars Framework works hand in hand with a proactive, transparent, and rigorous process for managing the organization's operations to meet strategic goals and annual operating objectives. A comprehensive management process provides accountability by tracking outcomes against objectives; reporting those results to management and the board of directors; and, adjusting, when necessary, should results fall short or wildly exceed expectations. The framework is a platform on which CDFI leaders can build systems of accountability to fulfill mission.

Equity and inclusion are ever-present elements.

CDFIs understand that an inclusive economy is critical for everyone. CDFIs work to uncover, name, and dismantle systems of bias and exclusion to ensure borrowers and communities get equal and fair access to quality jobs, affordable housing, healthcare, education, and the chance to build wealth for themselves and their families. It is important that this work happens inside CDFIs, not just in the communities they serve. CDFIs can scan for possible unconscious bias, structural discrimination, and systematic exclusion within the tools, processes, and practices they create or participate in. See the Appendix for an example of a tool ("Race Forward Racial Equity Impact Assessment (REIA)Tool for Programs/Initiatives") that can be used to reduce, eliminate, and prevent racial discrimination and inequities during decision-making processes.

Essential Pillar 1: Clear Statement of Mission and Strategic Goals

What it is

A CDFI's effectiveness begins with a clear understanding of its purpose and focus. This is typically implemented in the form of a mission statement, which is a long-term declaration of its reason for being. All strategy and tactics flow from that foundational purpose and focus. This pillar also requires strategic planning, a more near-term exercise to develop goals that articulate how the CDFI will actualize its mission over a given timeframe (typically three to five years) and within a given community or market.

Why it matters

This pillar plays a unique role among the four elements of the framework. It is the proverbial heartbeat of a CDFI, answering the fundamental "why" of a CDFI's existence. Without the core elements of clear mission, focus on who you are serving, and strategic direction, all other pillars are like a meandering ship without a rudder, directionless in a sea of community need and market change. The work of determining a definitive mission, market, and corresponding strategy should result in a clear understanding of the community needs that are being addressed, which borrowers or end users are being served, and the

CDFI’s role in serving the community through addressing the needs of their borrowers or end users.

Key components of this pillar

Mission statement

- A well-written mission statement serves as a CDFI’s true north, providing direction for organizational strategy and clarity to the public about the role a CDFI plays in supporting community change.
- It should be broad enough to allow the organization to undertake new activities in the future that are within its purpose.
- It should also be specific enough to provide guardrails that will help management determine which activities it should not undertake, stopping short of prescribing tactical or operational goals and objectives.
- The best mission statements are community-driven, data-informed statements that use accessible and descriptive language to bring a CDFI’s “why” to life.

From a governance perspective, a CDFI’s board of directors is responsible and accountable for mission fulfillment and delegates operational authority to the staff executive and their designees to execute the mission. Practically speaking, staff leaders often drive development of the CDFI’s mission, codified in the mission statement, and then it is formally adopted via a vote of the full board. It is the responsibility of the board to monitor the CDFI’s performance in fulfilling that mission.

Target market definition

- The purpose of a CDFI is to bring about long-term positive change in the communities it serves. To accomplish this, CDFIs should move beyond broad descriptions of ways it can do good and have a sharp focus on the specific people and/or places they are working to serve and the kind of impact they endeavor to have with products and services designed to meet the specific needs of those people/places.
- The CDFI Fund holds certified CDFIs accountable to their mission by asking them to define their “target market(s).” A certified CDFI must serve a target market by virtue of serving one or more investment areas or targeted populations. Investment areas meet specific geographic and socioeconomic criteria, as defined by the CDFI Fund, while targeted populations are individuals who are low-income, African American, Hispanic, Native American, or Native Hawaiians residing in Hawaii, Alaska Natives residing in Alaska, or other Pacific Islanders residing in American Samoa, Guam or the Northern Mariana Islands. To maintain certification, all certified CDFIs must submit annual reporting to the CDFI Fund, including an attestation that it meets a 60% target market threshold.
- An effective CDFI can draw a clear and precise line linking its mission to its target market and then to strategic goals set to reach the target market in order to fulfill mission.

Strategic planning

- To ensure accountability to mission, the board in collaboration with staff leadership engages in strategic planning.
- This is the process by which a CDFI translates its mission into objective and measurable goals that are actionable, provide transparency and clarity, and help define what success looks like on an ongoing basis.
- Strategic goals are important because they drive operational priorities, allocation of resources, capability requirements, and budgeting activities. They inform individual and team objectives used to focus and align the efforts of all employees (lending, operations, finance, IT, and human resources). They also provide benchmarks for measuring actual versus intended results.
- As part of strategic planning, organizations should strive to include key stakeholder input. Key stakeholders generally include the CDFI's board of directors, staff, clients, funders, and key partners. Gathering feedback from key stakeholders will help the management make informed decisions about strategic direction for the organization.
- CDFIs should have a board-approved strategic plan that includes, at a minimum, objective and measurable goals and objectives that encompass the five areas listed below. Strategic plans most typically cover a period of three to five years; however, shorter or longer time frames may be used, depending on the CDFI's planning purposes.

Strategic goals and related objectives should include the following areas at a minimum:

- *Impact*: This is defined as the measurable outcome or impact the CDFI strives to achieve through deployment of its capital and technical assistance.
- *Deployment or Financing*: This includes the types and levels of deployment of financial products or delivery of services and technical assistance essential to the borrower or end user's success.
- *Capitalization*: A written capitalization plan ensures the CDFI has sufficient funding to meet deployment goals while maintaining its financial strength.
- *Organizational Development:* The CDFI must manage organizational capacity and its operating budget to meet its strategic goals.
- *Financial Performance:* This focuses on those performance metrics that indicate the CDFI's financial strength to support its mission.

Annual operating plan

- Once a CDFI has done the important work of defining its mission and developing a strategic plan to actualize that mission, it is time to link strategic goals with the daily activities of the CDFI.
- A written annual operating plan aligns the CDFI's tactical deployment to its achievement of strategic goals for each year of the strategic plan. The annual operating plan should identify: (1) the key activities needed to achieve the desired goals and objectives identified in the strategic plan, (2) the staff or board member

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who will be responsible for ensuring each activity gets completed, (3) a detailed monthly or quarterly timeline for completing each activity, and (4) any new budget items resulting from each activity.

- A CDFI's annual budget is the financial result of its annual operating plan.

Functional feedback loop

- To manage accountability to mission, strategic goals, and annual operating objectives, management should consider creating a functional feedback loop with the board.
- That work begins with regular staff review of the organization's performance against the board-approved metrics and operational goals.
- The results of staff work can then be reviewed by management, and tactical adjustments can be made based on performance.
- Finally, the results of the organization's success against board-approved metrics can be reported to a CDFI's board at regular meetings.

Recap

- This pillar answers the fundamental "why" of a CDFI's existence.
- A mission statement should be broad enough to allow the organization to undertake new activities in the future that are within its purpose while specific enough to provide guardrails that will help management determine what activities it should not undertake.
- A clear and precise definition of the people and/or places a CDFI is created to serve is important.
- Strategic planning creates accountability for a CDFI to its mission.
- An effective CDFI can draw a clear and precise line linking its mission to its target market and then to strategic goals set to reach the target market in order to fulfill mission.

Pro tips

- More is less when working to define target market and in strategic planning. A CDFI is better served doing a few things well rather than creating many goals or serving many target markets in a mediocre way.
- A holistic strategic plan should enable a CDFI to complete the following sentences: [CDFI] will know it has met its mission when by [insert year] it has impacted the communities it services in the following ways [insert impact metrics] by its work deploying [insert deployment goals]. [CDFI] will do this by raising [insert dollars in capital needed] and growing organizational capacity by [insert goals such as increase in people or operating budget] and meeting the following financial sustainability goals [insert self-sufficiency, net assets goals, etc.].

Essential Pillar 2: Lending Strategy

What it is

This pillar covers the "what" of CDFI work. A CDFI's lending policies and procedures detail loan product(s), staff responsibilities, loan risk management, and other items that describe the deployment of a CDFI's financials products and services and corresponding risk mitigation strategies to ensure mission success. The primary tool CDFIs use to codify this pillar is a board-approved loan policy manual. Procedures are codified separately and typically approved by management or a loan committee.

Why it matters

The lending strategy pillar serves as a programmatic playbook for a CDFI's staff. The CDFI's board is responsible for approving the high-level policies that guide lending while the staff is responsible for executing the policy. The staff oversees procedural needs and priorities that flow from the loan policy. A strong lending pillar provides a CDFI with a robust set of tools to build, then grow a vibrant lending program that effectively meets the specific needs the CDFI has identified for the communities it serves while mitigating risk for the CDFI.

Oversight of staff compliance with lending policies ensures they are being applied consistently and effectively from origination through payoff for both individual clients as well as the portfolio at large. A CDFI's loan policy makes explicit the key responsibilities of the compliance function.

Key components of this pillar

Financing products

- CDFIs deploy a variety of product types to meet community needs.
- A CDFI's loan policy should outline in clear detail each product's intended market, use, dollar range, terms, and conditions.
- The CDFI may also choose to make explicit the link between the products and the larger mission and impact of the CDFI.
- The number of products a CDFI deploys often depends on the CDFI's years in business, financing sector(s), and funding sources.

The following are examples of common product types within the CDFI industry's key financing sectors:

Micro/Small Business Sector

- Term loans: repaid in regular payments over a set period of time with interest that is typically fixed.
- Lines of credit: a defined amount of money available to access as needed and repay either immediately or over time. Interest is typically charged beginning when money is borrowed. Typically renewed annually and has an annual servicing fee.

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- Royalty or revenue-based financing: capital from investors who receive a percentage of ongoing gross revenues for a business in exchange for the money invested.
- Seasonal loans: loans made with interest-only periods that align with a business's seasonal cash flow.
- Participations: a method of sharing or selling interest in a small business loan whereby two or more lenders contribute funds to a single lending transaction.
- Commercial real estate: a mortgage secured by a first or second lien on a property used for business purposes. The property may be owner-occupied or leased.

Affordable Housing and Homeownership Sector

- Mortgages: a real estate loan secured by a first or second mortgage that provides funds to buy or improve a single-family home or other residential property.
- Down-payment assistance or closing-cost loans: a loan that provides funds to help a homebuyer with either down payment or closing costs for the purchase of a home.
- Housing development loans: this includes land acquisition, pre-development, construction, mini-permanent, permanent, and gap financing for residential properties.
- Developer financing: loans to developers to support the pre-development and development of a commercial real estate project. Loans include pre-development for early-stage development expenses, exploratory work, and soft costs; and development loans that include short-term construction and bridge loans as well as longer-term permanent loans.

Nonprofit and Community Facilities Sector

- Commercial real estate: a mortgage secured by a first or second lien on commercial property that is being purchased or improved for community purposes (e.g., community center, health clinic, etc.).
- Working capital lines of credit: a defined amount of money that can be accessed as needed for working capital purposes and then repaid either immediately or over time. Interest is typically charged beginning when money is borrowed. Typically renewed annually and has an annual servicing fee.
- Participations: a method of sharing or selling interest in a community facilities project whereby multiple lenders contribute funds to a single lending transaction.
- Nonprofit loans: a loan to a nonprofit organization that is most often used to support capital or operating expenses.

Consumer Sector

- Credit-building loans: a term loan that is provided to a borrower for the sole purpose of helping to establish or increase the borrower's credit score.

- General consumer loans: a term loan that often requires very little documentation. It can be used for consumer purchases, personal expenses, or other purposes.
- Auto loans: a term loan used to purchase a vehicle. The lender is the lienholder on the title to the vehicle until the loan is repaid.

Intermediary Sector

- CDFI loans: a loan to a CDFI most often for lending capital that is typically structured as a single payment loan where all principal is due at maturity and interest is typically paid monthly or quarterly.
- Participations: a method of sharing or selling interest whereby multiple lenders contribute funds to a single lending transaction to a CDFI.

Core elements of lending policies

A CDFI's loan policy articulates how the organization defines risk and guides staff in mitigating that risk while maximizing mission fulfillment. CDFIs were created to provide capital to people and communities left out by traditional financial institutions, and their loan policies should reflect that mission. A CDFI's board loan committee typically has oversight of the loan policy.

Loan product descriptions

- A CDFI's loan policy should include objective and accurate descriptions of each of its loan products to include, at a minimum, the intended borrower profile, loan size range, term, and uses.
- Some CDFIs also include the intended benefit of the loan for the borrower.

Loan underwriting

- A CDFI's underwriting guidelines should help the organization manage its credit risk, which should go beyond that of a traditional lender.
- CDFIs should generate guidelines that incorporate an equity lens, ensuring they are not perpetuating the barriers to capital access created by traditional lenders.
- All products should have underwriting guidelines and the guidelines should be appropriate for each product type.
- Underwriting criteria should be objective. For example:
    - Financial capacity to service the debt
    - History of repayment of debts over time
    - Available assets if the loan is secured
    - Level of the borrower's investment

Loan approval

- A CDFI assigns authority to approve loans as a risk mitigation strategy. A CDFI must specify who has authority to approve loans and define the parameters for approval.
- CDFIs implement various levels of authorization to support efficient loan approval processes while appropriately managing risk: the riskier the credit, the more robust the level of review should be. The levels of authority are typically: internal within the lending team; internal senior management; external committee; and board-approval. Increased risk of a credit, typically tied to loan size, requires a higher level of review and approval. An origination team typically has authority to approve loans up to a certain size, above which approval is assigned to senior management and an external loan committee.
- An external loan committee should be comprised of individuals with the appropriate skills, experience, and expertise to evaluate a loan decision within a CDFI's sector, at least some of whom also have specific knowledge and insight of, or are members of, the communities the CDFI aims to serve.

Loan risk rating

- From a credit perspective, a risk rating score is recognized within the CDFI industry as a tool to assess the risk of a loan during underwriting and to support accurate, ongoing portfolio management.
- A risk rating should include a set of objective measures against which the credit can be analyzed. Examples are credit history, debt ratio, profitability, liquidity, owner-equity infusion, experience in the industry, etc.
- A good risk rating policy ensures CDFIs are balancing risk adequately at the portfolio level and have procedures in place to closely monitor and manage loans based on risk rating guidelines.
- Risk ratings also play a critical role in determining reserves through the loan loss reserve policy, which is discussed in the next section.

Loan loss reserves

- From a financial management perspective, a loan loss reserve policy ties the level of reserve for each loan in the portfolio to a risk rating, and usually includes a protocol that lending and/or portfolio management staff follow to track the amount of loan loss reserve required by the policy. Please note: given changes to financial accounting standards, related to the required implementation of a new credit impairment standard for financial assets- Current Expected Credit Losses (CECL) in place of an Allowance for Loan Losses (ALL)- loan loss reserve accounting approaches may change moving into 2023 and beyond.
- A CDFI loan policy should include a protocol for reconciliation of the level of loan loss reserves required by the CDFI's loan loss reserve policy and the level of reserves in the allowance for loan loss on the organization's balance sheet. The protocol prescribes the process by which portfolio management staff report the amount of loan loss reserve required by policy, which is tracked in the portfolio management software. It is important that the portfolio management and finance teams work together to ensure reserves are set appropriately. It is typically done on a quarterly

basis but may be done monthly or annually depending on the size and financial capacity of the CDFI. Reconciliation is a particularly critical function in a stressed economic environment where delinquencies may increase and CDFIs can proactively adjust reserves to ensure they are prepared for any negatively trending risk in the portfolio.

Portfolio management

- Successful portfolio management is comprehensive and consistent.
- Portfolio management includes all functions needed to manage the risk of the loan portfolio from closing until repayment or charge-off. In addition to loan closings, this includes the onboarding and servicing of loans, monitoring performing loans, managing delinquent loans, loan fund compliance, and portfolio quality review.
- A CDFI should have policies that guide staff in each of the portfolio management areas. Successful stewardship of a portfolio is essential for mission fulfillment for any loan fund. This area of loan policy deserves significant time, attention, focus, and ongoing monitoring.

Loan closing, onboarding, and servicing

- Loan policy provides guidelines on approval authority for loans to be cleared to move to closing. The policy details requirements for accurate and consistent document collection, organization, and storage for active loans.
- The policy also provides parameters on the collecting and recording of payments.

Loan monitoring

- A robust loan policy provides guidelines for monitoring performing loans in the portfolio, which allow CDFIs to monitor the financial performance of the borrower and identify any material change that may affect repayment.
- Loan monitoring and analysis is typically based on a loan's performance and its associated risk and may include borrower submission of financial statements, the frequency of which is determined by the level of risk that loan represents.
- Standard practice is an annual review of performing loans that includes a review of the borrower's financial performance and the risk rating. It may also include a site visit. For secured or asset-based loans, a review of collateral or asset values is included to ensure valuations are current.

Managing delinquent loans and troubled assets

- Inevitably some CDFI borrowers will run into challenges. When that happens, a CDFI must respond to both support the borrower and mitigate risk.
- In the case of past-due accounts, it is important that the CDFI understands whether the change in payment performance is due to changes of a temporary or permanent nature. This will help determine the course of action the CDFI should take in support of its borrower. A CDFI's loan policy typically outlines the steps to take in each case.

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    - If the situation entails a temporary impact on payment performance, a CDFI can remedy the situation by offering a payment extension, which does not change the underlying loan terms. Loan policy should provide clear parameters on the use of payment plans, which will then guide procedures for staff execution.
    - In situations where a long-term or permanent issue has negatively impacted payment performance, a restructure may be necessary to support the borrower. A restructure fundamentally alters the original terms of the loan and, therefore, requires underwriting review. Again, loan policy should provide clear parameters on restructures, which are often used only once over the life of a loan.
- A robust portfolio management loan policy also provides parameters in the event a CDFI must:
    - Pursue asset liquidation if the loan was secured or was structured in the form an asset-based loan
    - Charge off an account that has been deemed uncollectable, typically by a certain number of days of delinquency.

Loan fund compliance

- Compliance within the portfolio management area serves two purposes: 1) internal compliance with the loan policy to ensure borrowers are treated consistently and, more broadly, to ensure consistent risk management, and 2) ensuring that all funder covenants are being adhered to with lending capital
- A strong compliance policy assigns roles and responsibilities of staff in ensuring internal and funder compliance

Portfolio quality review

- Portfolio quality review (PQR) is the process by which a CDFI tracks and reports the performance of the portfolio and any concentrations of risk within the portfolio against board-approved metrics for each. Restructured loans are an example of a concentration of risk within a CDFI portfolio.
- A CDFI should develop policies and procedures for PQR that include, at a minimum, the following:
    - 12-month rolling trend analysis of delinquencies and defaults
    - Three-year historical analysis of delinquencies and defaults
    - Identification and tracking of concentrations of risk within the portfolio
    - Limits of concentrations of risk to ensure a well-balanced portfolio
- Typical concentration risks are product type, loan size, and sector.
- OFN’s annual "Side by Side" reports can provide CDFIs of all sectors baseline thresholds for delinquency and defaults. (See Appendix.)
- Portfolio performance reporting should be integrated into the CDFI’s functional feedback loop. Typically, a CDFI board sets performance metrics for the portfolio as

part of the annual operating plan and then reviews the portfolio's performance against those metrics at regular meetings.

Recap

- This pillar gets deep into the "how" of a CDFI's mission. The work here operationalizes the mission, target market definitions, and strategic goals of the first pillar.
- Be explicit about each product's intended market, use, dollar range, terms, and conditions.
- A CDFI's loan policy articulates how the organization defines risk and guides staff in mitigating that risk while maximizing mission fulfillment. The investment a CDFI makes in developing its loan policy is important.

Pro tips

- Focus on the specific loan products that have been identified as priorities in addressing capital gaps in the market. For emerging or early-stage CDFIs, consider no more than three products for initial launch.
- Consider setting concentration thresholds that are percentages of total portfolio size to diversify the portfolio and mitigate risk so that the guidelines can support a growing portfolio.
- CDFIs can struggle with organizational development when portfolio management lags origination. CDFIs focused on growth may work hard to organize resources to generate loans and are wise to direct equal – if not greater – attention to building out portfolio management resources necessary to support a larger portfolio before the increased loan volume starts flowing.
- The CDFI industry uses a variety of terms to describe and report on loan portfolio quality. Certain terms are and can be used interchangeably while others have a different specific meaning to certain key industry stakeholders such as regulated banks. OFN published a white paper, "Performance Counts: Best Practices for CDFI Financial Statements and Management," to provide financial best practices, guidance, and financial statement standards for CDFIs. (See Appendix.) CDFIs can review that document to understand the terminology of portfolio management and make informed decisions about the terms they use within their organization. Please note that terms are subject to change based on evolving accounting compliance standards.
- OFN's annual "Side by Side" report provides data on more than 100 CDFIs. (See Appendix.) A CDFI can use this report to compare its activities and performance to a peer group of similar organizations, which can help a CDFI make management and operational decisions to improve its performance.

Essential Pillar 3: Organizational Infrastructure

What it is

The third and fourth pillars comprise the "how" of a CDFI's work. The organizational infrastructure pillar reflects how a CDFI mobilizes organizational capacity to execute its mission, strategy, and lending activity. This includes the human resources, systems, and structures required to deploy financial products and services and manage the loan portfolio as well as manage the day-to-day back-office operations, finances, and fund development activities of the CDFI.

Why it matters

It is not uncommon for organizational growth to outpace an organization's capacity in some way. Among the four pillars, organizational infrastructure can at times be unintentionally deprioritized. A CDFI's public-facing service in the community is only as good as its internal-facing work to build consistent, reliable, and efficient organizational horsepower.

Key components of this pillar

Governance

A CDFI board of directors is responsible for setting the vision for the CDFI and providing risk oversight to ensure the organization is financially strong while meeting its mission.

- The governance structure of a CDFI is essential to its ability to meet its mission as effectively and efficiently as possible.
- A high-functioning board of directors typically institutes term limits for its officers and members. Board term limits offer many benefits to an organization, including creating a leadership pipeline, introducing new people and their networks to the organization, and making space for new skill sets and expertise responsive to changing needs of the organization and its target market. Terms should be staggered to ensure that institutional knowledge is preserved and transferred during transitions.
- Board composition is important as members should possess the breadth of skills and expertise needed to create a well-rounded CDFI board. CDFIs can use a board assessment tool to determine gaps in skill sets, demographics, target market representation, etc.

Each board typically has committees: the two that are essential for strong board oversight are the loan and finance committees.

- The loan committee is discussed in the Loan Policy section under Pillar 2.
- The finance committee of a CDFI is critical to oversight of the organization's overall financial performance and risk. For example, it is responsible for ensuring the CDFI is well-reserved for the risk present in the portfolio, has the liquidity necessary to meet its debt obligations, and is financially positioned to attract the types of capital

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needed to drive its mission. CDFI industry standard is for the board treasurer to chair the finance committee. Additional at-large committee members should have experience with audit procedures, public accounting, and expertise in CDFI finance, which is distinct from traditional nonprofit or for-profit finance.

CDFIs may also use advisory boards to support their accountability to their target markets.

- Advisory boards should meet the CDFI Fund's certification requirements for target market representation and provide direct feedback on elements of the CDFI's programmatic reach and performance.
- These boards can also serve as liaisons and ambassadors for CDFIs to reach key communities or constituencies more effectively, and to stay abreast of emerging challenges in their markets.

Management

- Managing organizational infrastructure is a shared responsibility across key staff positions, namely the chief executive, lending leader, finance leader, portfolio manager, and human resource leader.
- In small or emerging CDFIs some or all of these functions may reside in a single staff member or be shared among two or three. In larger or mature CDFIs, there may be a team leader to oversee these functions and some of the more technical aspects of infrastructure management — namely IT — may be outsourced to a third-party vendor with that expertise.
- It is recommended that the staff leader or leadership team review the efficacy of organizational infrastructure on a regular basis to determine where new policies or procedures, system upgrades, or capital investments are needed.

Functional organizational chart

- The appendix includes a Functional Organizational Chart that outlines the key functions of a CDFI and how they can be organized to maximize performance, provide appropriate checks and balances, and leverage efficiency. It details the three major areas of work within a CDFI — lending, finance, and development.
- The finance/administration area in the appended organizational chart is the key driver for organizational infrastructure, typically overseeing the accounting, administrative, IT, and HR functions. That department or unit may also oversee the portfolio management function.
- The lending area can have three distinct functions — origination, portfolio management, and pre-and post-closing technical assistance.
- The development function typically oversees fundraising, marketing, PR/events, and funder compliance.
- The organizational chart can help CDFI leaders think through staffing alignment that ensures key functions are integrated into a staff structure designed for optimal performance.

Staffing

Staffing structures and approaches may evolve to meet the shifting needs of the community and CDFI employees.

- Building out the staff team of a CDFI is a process that can vary widely across the industry.
- CDFIs should stay on top of workforce trends in remote and hybrid work environments as well as state and federal labor laws to ensure they are recruiting talent while meeting statutory requirements as an employer.
    - For example, all CDFIs should be aware of Occupational Safety and Health Administration (OSHA) compliance laws: organizations with more than 50 employees are subject to a new level of statutory requirements, such as the Family Medical Leave Act (FMLA).

Meeting human resource needs through full-time staff, contractors, and vendors is a balancing act.

- Full-time equivalent staff ("FTEs") represent a direct and permanent expense to a CDFI's budget, and CDFIs should carefully manage the costs of taking on FTEs. It is common for small or emerging CDFIs to have a smaller staff team and rely on part-time positions, consultants, or third-party vendors to meet resource or capacity needs during early-stage growth. Most larger or more established CDFIs have a fully developed team of FTEs and use outside contractors or third-party vendors for special projects or technical work that requires subject-matter expertise not available in house.
- When using outside resources or third-party vendors, it is important that CDFIs ensure they have the capacity to manage those resources closely.
- It is also important that CDFIs do not "outsource" core functions on a permanent basis. For example, contracting with a consultant to provide underwriting support can be a helpful gap measure but is not a sound long-term solution to staffing issues. Underwriting is a core competency that should reside within the staff in the long term. The same is true for loan servicing and the finance function.

Technology systems

- Like staffing, technology systems can vary widely across CDFIs based on size, sector, and length of time in operation. It is essential for CDFIs to embrace digital literacy as part of their operational approach to maximize efficiency and impact.
- Typical technology systems include accounting, lending/loan servicing, and customer relationship management (CRM) software. These may be separate or integrated. Other technologies may include impact tracking, online applications, and client interface.
- The following are questions CDFIs may use to evaluate the sufficiency and effectiveness of their current IT environment:
    - Are there systems in place to sustain a remote work environment should that be necessary?

- Is there reliable, secure, accurate, and efficient access to current data about the financial health of the organization and the performance of the portfolio?
- Are there any single points of critical failure within the IT environment where additional systems or support could mitigate risk?
- Can staff reliably and consistently collect borrower payments, pay employees, and process accounts payable and receivable?
- Does the organization have a business continuity plan in place that includes network or systems failures in the event of a natural disaster or terrorist attack?
- Can borrowers efficiently and consistently access information about the loan application process and apply online?

Cybersecurity

- With increased reliance on IT infrastructure comes greater risk of cybersecurity threats. While most CDFIs are unregulated financial institutions, all should approach this area of risk with discipline by performing regular audits of cyber security threats, providing training to staff members about risks and vulnerabilities they can help identify, and providing capital investment in the systems necessary to protect client and funder information.
- Key questions to consider in this area include:
  - Does the organization have a business continuity plan in place that includes guidelines, resources, and key crisis management steps in the event of a directed cyber-attack on the organization's systems?
  - Is sensitive information about borrowers, employees, and funders reliably and safely stored and backed up?
  - Is there a set of protocols in place for employee use of email and online tools to include ongoing training on cyber vulnerabilities, such as phishing techniques and email scams?

A sample CDFI cyber security policy can be found in the Appendix.

Organizational insurance policy

- A core part of any institution's risk management approach is sufficient insurance coverage across all appropriate areas of business operations.
- Key areas CDFIs should review with their insurance agent or broker to ensure they are sufficiently covered include the following:
  - General Liability
  - Professional Liability
  - Commercial Property Insurance
  - Workers' Compensation
  - Directors and Officers Liability
  - Cyber Liability

Business continuity and succession planning

- CDFIs should have a written plan to support business continuity that outlines a procedure to assess risk within the organization and ensure proper controls are in place to mitigate risk.
- The plan should include a threat analysis and risk mitigation steps for disasters and interruptions to business continuity. It should also articulate a response and recovery procedure and name a recovery team should that be needed.
- Succession planning supports business continuity. A CDFI should have a written succession plan in place for all key staff and board leadership positions and for any staff position that holds significant operational responsibility. In many cases, the successor may be another member of the staff or board.
- Essential elements of a succession plan are the names of successors for each essential position and a process for review of the successors any time there is a change in board or staff composition.

Recap

- This pillar represents the organizational backbone and reflects how a CDFI mobilizes organizational capacity to execute its mission, strategy, and lending activity.
- A CDFI board of directors is responsible for setting the vision for the CDFI and risk oversight to ensure the organization is financially strong while meeting its mission.
- Staffing strategies center on the key functions of a CDFI — lending, finance, and development — and how they can be organized to maximize performance, provide appropriate checks and balances, and leverage efficiency.
- The modern workplace requires strong focus on leveraging IT systems, managing potential risks of cyber-attacks, and ensuring sufficient insurance coverage is in place.
- Business continuity and succession planning is essential for long-term sustainability.

Pro tips

- CDFIs operate in a dynamic, rapidly changing world. This requires practitioners to be agile and adaptable while maintaining rigor in the foundational elements of CDFI strategic management and operations. CDFI leaders can embrace the spirit of the scientific method by developing new ideas, services, and products, testing them in action, then thoroughly assessing results. By testing, assessing, and repeating what works, CDFIs can effectively and efficiently grow their mission in ways that are replicable and sustainable.
- An annual organizational risk assessment that reviews IT infrastructure and vulnerabilities, business succession and continuity planning, and insurance coverage can help ensure staff leadership has the tools and plans in place for unforeseen events and crises.

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Essential Pillar 4: Financial Strategy

What it is

This fourth and final pillar completes a view of the "how" of a CDFI's work. Financial strategy includes cash management, sustainability, and risk management functions within an organization. A CDFI's financial results are an outcome of the decisions leaders make about products and services to provide, pricing of those products and services, the CDFI's operational efficiencies, its cost of capital, and asset design and acceptable risk.

Why it matters

CDFIs are, by definition, financial institutions, so rigorous and transparent management of fiscal matters is vital. This pillar underscores the mutually reinforcing nature of the entire framework as decisions made in the other three pillars have a direct impact on the CDFI's finances. Conversely, this pillar can also serve as a driver for all other pillars. Financial performance can fuel — or hamper — a CDFI's deployment, infrastructure, staffing, systems, and, ultimately, mission fulfillment.

Key components of this pillar

Budget

Budget planning yields an operating budget, which provides the CDFI with a short-term tool to monitor financial performance.

- It is focused on ensuring sufficient revenues, controlling expenses, and monitoring the relationship between the two in the form of a positive, break-even, or negative operating margin.
- It is important to note that budget planning is only the first step in financial strategy work. Budgeting typically will happen as an iterative process when developing the annual operating plan. This helps ensure the budget aligns with annual goals and plans.

An important consideration on the revenue side is product pricing.

- It is important that CDFIs consider the full cost of deploying their products and services in support of the communities they serve. While a CDFI often does not pass all those costs on to the borrower, it is important that a CDFI understands the full cost picture. This will also help management understand the amount of subsidy required to cover costs.
- On the expense side, CDFIs should also keep an eye on cost of capital, particularly in relation to product pricing.

The interest rate margin is an important factor in a CDFI's financial health and sustainability.

- This margin reflects the difference between loan product interest rates and cost of capital.

- As discussed below, key financial ratios can be a helpful tool when monitoring the impact of these types of revenue and expense drivers, including self-sufficiency and earnings.

Financial projections

- Core to sound financial strategy management is the development of multi-year financial projections. These projections help a CDFI explore and manage the complex relationship among deployment, capitalization, and organization growth goals and their impact on the CDFI's financial performance to include financial statements.
- Projections also provide the CDFI with the information necessary to develop a multi-year capitalization strategy, which serves as a road map for organizational growth.
- The iterative process to develop multi-year financial projections provides the CDFI's leadership the opportunity to balance deployment, capitalization, organizational growth, and financial performance goals. Projections will include assumptions about deployment goals, loan losses, earned revenue, cost of capital, growth in operating expenses tied to growth in staff, and key financial performance benchmarks.
- The projections will drive long-term capitalization planning and an annual operating budget for each of the projected years. It is important to review and revise projections on at least an annual basis.

Cash management

CDFIs need to proactively manage cash flow by developing cash flow projections.

- A typical CDFI should have anywhere from three to 12 months of operating cash on hand to cover ongoing business expenses. This level of operating cash will also help mitigate against the often unpredictable timing of grants and protect against a temporary interruption in revenues.
- The higher the unpredictability of cash flows and the lending environment, the larger the cash reserve needed.

CDFIs need to consider cash management of lending capital.

- Determining an appropriate lending capital deployment ratio will help ensure a CDFI is maximizing impact and return on capital while protecting against unexpected increases in demand or loan losses.
- Lending capital cash flow projections will also measure incoming loan receivable payments against outgoing debt capital repayments to investors to ensure a CDFI has adequate cash in the bank to meet upcoming debt obligations.
- This form of asset liability management will also help identify if there is a mismatch between a CDFI's loan product terms and its debt capital terms. For example, a CDFI offering a 30-year mortgage product using five-year debt capital may find itself in a cash crunch when the debt capital payments come due.

CDFIs update cash flow projections regularly.

- At a minimum, even an organization with strong cash balances, a simple business model, and a very stable operating environment should update its cash flow projections annually.

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- As a CDFI grows and its funding sources become more complex, cash flow projections may need to be updated quarterly or even monthly.

Capitalization

A CDFI needs three types of capital to drive mission.

- They are as follows: 1) lending capital, which can come in the form of a loan/investment or as granted equity; 2) capital for loan loss reserve, which is raised from grant funding and can also be supported through earned revenue; and 3) operating capital, provided through earned revenue and raised from grant and debt funding.

A goal of capitalization planning is to position the organization for new funding.

- Capitalization planning, supported by the additional financial management steps described in this section, will help position a CDFI to acquire debt and leverage new grants and equity capital. A written capitalization plan that ties to strategic capitalization goals should outline a clear path to raise enough of the appropriate types of capital needed to drive growth while preserving existing assets.
- Potential investors will want to understand in clear detail the historical and current financial performance of the organization as described through audited financial statements, a current operating budget, current cash flow, and a minimum of two- to three-year financial projections.

Diversification is important.

- It is important that CDFIs keep in mind funding diversification across all capital categories including funding source and type of capital.
- For example, a CDFI would be wise to pursue new sources of grant funding to support operations if it has been relying on one or two public funding sources to keep the doors open. Conversely, if a CDFI has a concentration of loan capital from one or two private-sector sources (often banks), a new public-sector source could be added to the loan capital mix.
- Strong capitalization planning supported by sound financial management will help a CDFI maintain a healthy capital mix.

Financial management

CDFIs should evaluate and manage their financial health against industry-standard processes and other relevant ratios.

- Typical ratios are deployment, asset quality (i.e., delinquency and charge-offs), earnings, self-sufficiency, and liquidity. A CAMEL(S) review looks at capitalization and capital structure, asset quality, management, earnings, liquidity, and sensitivity.
- Management should set regular financial targets as part of the strategic and annual planning processes. Ongoing measurements of these targets should be reviewed by management and presented to the board on a regular basis.

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The development and compliance functions are important tools.

- These functions of a CDFI provide mechanisms for raising enough of the right types of capital needed to drive mission while ensuring the CDFI is meeting all funder covenants.
- A CDFI should have a proactive system for managing funder compliance with assigned staff supported by policies and procedures.

Industry standards call for a staffing structure and written financial management policies and procedures that cover capital raising, internal controls, and compliance reporting.

- There should be a protocol in place for programmatic and finance staff when new capital comes into a CDFI, which details their responsibilities for collecting, tracking, and reporting deliverables to the development staff and the timeline for that reporting to both funders and management.

A foundational element of financial management is the annual audit.

- A key step is selecting the right audit firm. CDFI finance is distinct from other types of finance and calls for an understanding of accounting rules and approaches that fall outside traditional nonprofit accounting.
- Broadly, CDFIs should research and review a potential auditor's qualifications, experience with CDFIs, quality assurance processes and fee structure.
- The best auditors serve as partners with clients, providing clear and constructive feedback as well as ongoing support for management.

Recap

- A CDFI's financial results are an outcome of the decisions leaders make about products and services to provide, pricing of those products and services, the CDFI's operational efficiencies, its cost of capital, and asset design and acceptable risk.
- Multi-year financial projections help a CDFI test and manage the complex relationship among deployment, capitalization, and organization growth goals and their impact on the CDFI's financial performance.
- Budget planning flows from the CDFI's goals and financial projections, and yields an operating budget, which provides the CDFI with a short-term tool to monitor financial performance. Important considerations include product pricing, interest rate margin, and staff growth.
- Cash management starts with cash flow projections that consider all types of capital flowing through the organization and are updated regularly.
- Robust capitalization planning positions a CDFI for new funding and helps to ensure diversification to mitigate financial risk.
- Robust financial management leverages industry-standard evaluation processes and ratios, attends to key compliance and development functions, and supports a strong annual audit process.

Pro tips

- The development of multi-year financial projections is both an art and a science. It is an iterative process of developing assumptions, identifying financial interdependencies, and testing thresholds for programmatic and financial performance.
- When looking for additional sources of cash flow, review current payment terms with vendors to see if there are opportunities to extend timeframes.
- When looking for an audit firm, ask colleagues in the CDFI industry for suggestions. Auditors with CDFI experience are harder to find but helpful given the differences between CDFIs and other nonprofit organizations as well as traditional financial institutions.
- A small or emerging CDFI has the same need as a larger and more mature CDFI for financial projections and forecasting but typically does not have those skills available among staff. A fractional CDFI CFO consultant is a good solution as it provides the skills without the onerous overhead of a permanent CFO FTE.

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Appendix

Tools and Resources

Race Forward Racial Equity Impact Assessment (REIA) Tool for Programs/Initiatives

Performance Counts: Best Practices for CDFI Financial Statements and Management

Sample Functional Organizational Chart (also included as Appendix A on the next page)

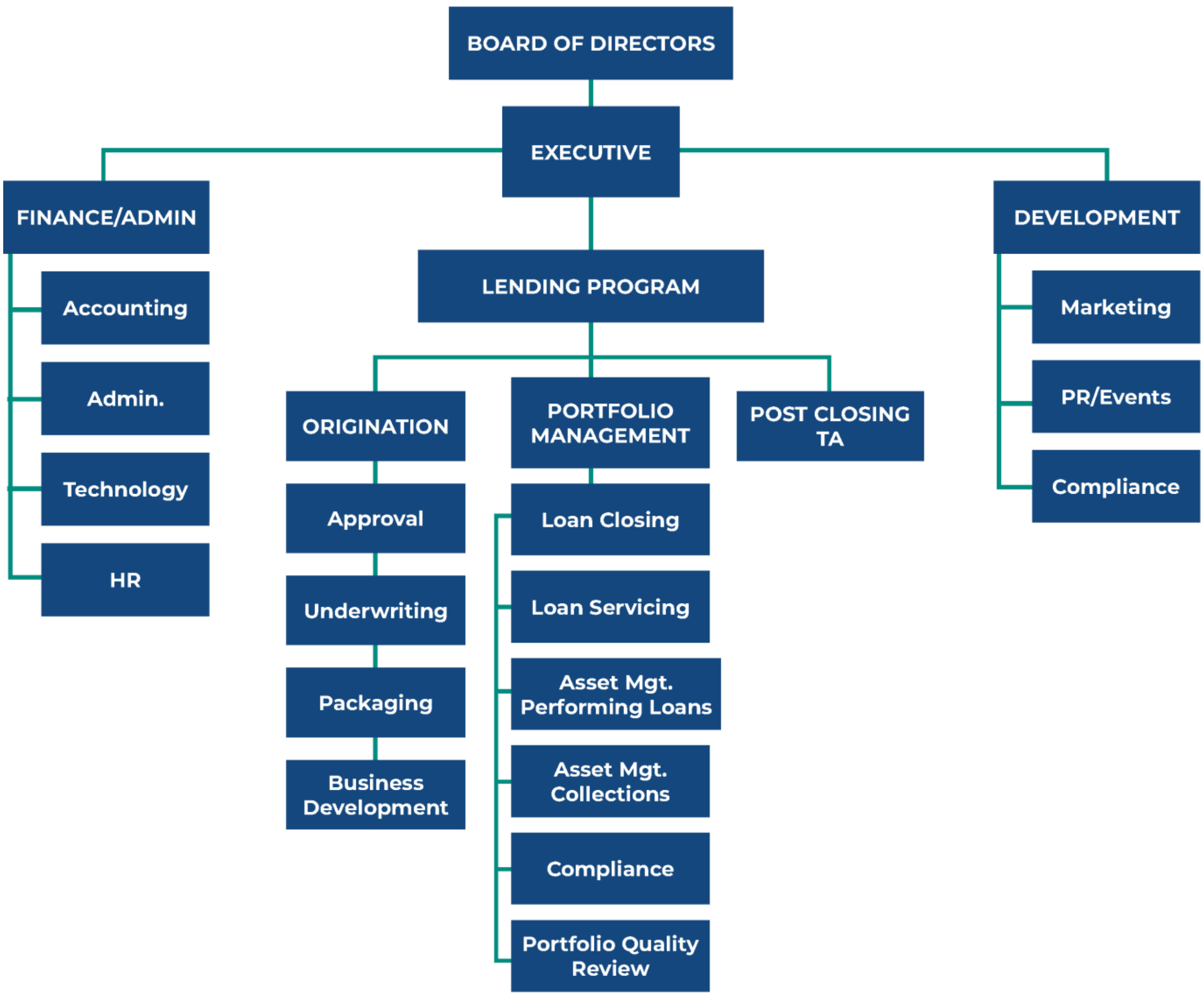
Sample CDFI Cyber Security Policy

Opportunity Finance Institutions: Side by Side, FY 2020 23rd Edition

CDFI Fund Resource Banks

Appendix A

Sample Functional Organizational Chart



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