



CDFI Liquidity and Cash Management

Definitions, Practices, and Examples



PERFORMANCE COUNTS

Best Practices for CDFI Financial Statements and Management

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I. INTRODUCTION

The Community Development Financial Institution (CDFI) industry has experienced unprecedented growth over the past few years, the result of a higher public profile and an increased awareness that CDFIs offer essential solutions to problems for low-income and low-wealth people and communities. With this growth and higher visibility comes greater scrutiny and accountability. While CDFIs have long been responsive to the communities they serve, their expansion and growth make it even more critical to communicate clearly and transparently to external stakeholders and investors about their financial position and stability.

In support of this purpose, Opportunity Finance Network (OFN) convened an industry-led initiative, ***Performance Counts: Best Practices for CDFI Financial Statements and Management***. An industry-led Working Group (the Working Group) meets regularly to develop standards and best practices for CDFI financial statements and management. Accountants and other professionals advise the Working Group.

The initiative's goals are to:

- Achieve greater consensus within the CDFI industry around financial metrics, financial statements, and reporting;
- Enhance financial management and best practices within the CDFI industry;
- Promote streamlined reporting and clearer messaging by CDFIs; and
- Increase access to capital sources by helping current and prospective investors better understand CDFI financial statements, financial performance, and financial wherewithal.

This paper is the third in a series addressing specific financial statement and financial management topics, with the goal of encouraging agreement and ultimate adoption of recommendations on how best to present CDFI financial information in a clear, standard, and transparent way. The previous two papers are, *Presentation and Classification of Grants and Net Assets in CDFI Financial Statements*, and *CDFI Portfolio Reporting: Definitions, Accounting Treatment, and Reporting Guidance*. OFN and the Working Group welcome regular feedback, as continuous communication regarding process and work product is critical to the success of this initiative.

II. ABOUT THIS PAPER

Liquidity is measured by the CDFI's ability to:

- Ensure adequate liquidity reserves in case of unexpected events;
- Ensure adequate liquidity for projected growth; and
- Fund assets and obligations in the most cost-effective way without unduly risking income potential.

Accordingly, appropriate liquidity management is about achieving the balance between risk and reward. Potential repercussions of poor liquidity risk management can include temporarily delaying loan disbursements, not making payroll, or defaulting on investor payments—any of which could result in serious damage to an organization's credibility and ability to function normally. Whereas, benefits of well-managed liquidity can include maximized income earned on all available assets and solid operating and capital cushions. Given that CDFIs' liquidity varies day to day, keeping the appropriate balance requires proactive and consistent liquidity management. Moreover, the differences between CDFIs require that each CDFI should establish and define its own individual liquidity policy, practices, and benchmarks tailored to its organization's product mix, financial situation, and long-term growth strategy.



This paper outlines standard definitions, items and issues to consider when establishing liquidity benchmarks and liquidity management tools. It is primarily targeted for CDFI loan funds, but some components are also applicable for CDFI banks and credit unions. This paper is organized to:

- Provide definitions and terminology most commonly used related to liquidity and cash management;
- Discuss various liquidity and cash management practices;
- Provide illustrative examples for how various CDFIs monitor and manage their liquidity and cash; and
- Discuss factors and issues when defining benchmarks for measuring liquidity.

III. TERMS AND DEFINITIONS

The majority of terms and ratios regarding liquidity management are not specifically defined by the Financial Accounting Standard Board (FASB) or Generally Accepted Accounting Principles (GAAP); instead, most definitions are commonly accepted in the financial industry. Table 1 outlines the commonly accepted definitions of liquidity terms and ratios. Discussion of how these terms are adapted and commonly presented in the CDFI industry is included in subsequent sections of the report. Commonly used liquidity ratios are also presented in a subsequent section of the report.

TABLE I. TERMS AND DEFINITIONS

Term/Ratio	Definition	Section/Page of Discussion
Liquidity	Liquidity measures the extent to which an organization has cash, access to cash, or assets that can be quickly converted to cash, to meet immediate and short-term obligations.	Liquidity and Liquid Assets (page 3)
Operating Liquidity	The availability of liquid assets to fund operating expenses of the organization. Typically measured as days or months of cash available to cover operating expenses.	Operating versus Capital Liquidity (page 6)
Capital Liquidity	The availability of liquid assets to fund loans and investments and to repay investors.	Operating versus Capital Liquidity (page 7)
Liquid Assets	Cash, cash equivalents, and other marketable securities that can be readily converted to cash.	Liquidity and Liquid Assets (page 3)
Cash Equivalents	Short-term, highly liquid investments that are readily convertible to known amounts of cash or are so near their maturity that they present insignificant risk of change in the value because of changes in interest rates.	Liquidity and Liquid Assets (page 3)
Marketable Securities	Any equity or debt instrument that are readily salable, listed on a tradable exchange, and can be converted into cash, or exchanged, with ease.	Liquidity and Liquid Assets (page 3)
Risk Management Committee	A committee in a lending institution that generally comprises the senior management levels of the institution focused on monitoring and managing the institution's risks.	Reporting and Oversight (page 15)
Operating Reserve	An unrestricted cash balance set aside to stabilize a CDFI's finances from potential short term cash flow shortages for operational needs.	Operating Liquidity (page 7)
Committed Lines of Credit	Committed revolving loans between a financial institution and a borrower with a specific maximum loan balance that the institution will permit the borrower to maintain. Borrowers can continue to draw down and repay the loan amount according to the terms of the agreement.	Liquidity Management Tools (page 13)



IV. LIQUIDITY AND LIQUID ASSETS

Liquidity measures the extent to which an organization has cash, access to cash, or assets that can be quickly converted to cash, to meet immediate and short-term obligations.

Liquid assets are not specifically defined under the accounting standards. A common definition of liquid assets used by the financial industry is: “cash, cash equivalents, and other marketable securities that can be easily converted to cash.”

However, understanding what assets are “liquid” is not enough to understanding a CDFI’s liquidity position or liquidity requirements as CDFIs need liquidity to both manage operations and meet capital requirements. Investors in CDFIs and other users of CDFI financial statements typically want a comprehensive understanding of what assets are available to pay for operating expenses, as well as what assets are available to make loans and repay investor obligations.

The following discussion addresses:

- What is typically included under the definition of “liquid assets”; and
- What additional information is helpful in terms of restrictions and limitations to understanding a CDFI’s liquidity position

Liquid Assets: Cash, Cash Equivalents, and Marketable Securities

As discussed above, liquid assets include “cash, cash equivalents, and other marketable securities that can be easily converted to cash.”

Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash or that are so near their maturity that they present insignificant risk of change in the value because of changes in interest rates. Generally, only investments with maturities of three months or less qualify under that definition. For example, both a three-month US Treasury bill and a three-year Treasury note with three months left to mature will qualify as cash equivalents.

Marketable securities are any equity or debt instrument that are readily salable, listed on a tradable exchange, and can be converted into cash, or exchanged, with ease. FASB requires segmentation of assets (and liabilities) into one of three levels based on the transparencies of the inputs to valuing the assets (or liabilities). For the CDFI industry, marketable securities typically include all Level 1 investments plus a portion of Level 2 investments.¹

Restrictions and Limitations on Liquid Assets

The above discussion focuses on what assets are considered liquid assets, but does not address the intended or required use of the assets. While there is specific accounting guidance on required disclosures of assets, this guidance leaves room for substantial variations on how CDFIs represent the limitations and restrictions on their liquid assets. Below we discuss the accounting guidance, as well as Performance Counts recommendations on additional disclosures.²

¹ Level 1 investments are easily converted to cash and those for which the fair value is determined by a publicly-quoted market price, accessible at the measurement date, on an active exchange—such as common stock of a company that is traded on the New York Stock Exchange. Level 2 investments are those where the fair value is determined by using “other observable inputs” (e.g., quoted price for a similar asset or liability on an active market). Level 2 investments include fixed income securities. If there is a liquid market for an investment (e.g., government agencies or mortgage bonds), a CDFI could count this as part of its “marketable securities” and liquid assets.

² FASB issued proposed changes in nonprofit financials which include additional disclosures related to liquidity. Performance Counts commented on the new proposed changes (including the liquidity disclosures). FASB is currently considering all comments and has not published a timeframe to disclose final changes to nonprofit financial statements.



Accounting Guidance

Appendix B includes guidance from the Audit & Accounting Guide (A&A Guide) about the treatment and required disclosures for cash and cash equivalents assets that are restricted or limited in use. Overall, the guidance is more principles-based than prescriptive. Determining the most appropriate financial statement presentation approach and/or footnote disclosure statements requires careful analysis, review of materiality, and best judgement by the CDFI in conjunction with its auditor. In general, the overriding principle is to break out and disclose restrictions and limitations on cash, cash equivalents, and investments in such a way as to not mislead the readers of the financial statement and associated financial notes.

The Guide also indicates that amounts received with donor-imposed stipulations restricting its long-term purpose (e.g., cash given to purchase a building or long-term asset) should be classified separately on the SOFP from assets that are available for current use.

Performance Counts Recommendations

The current A&A Guide language is open for interpretation and judgment about the distinction between which assets are restricted versus limited in use. The Guide is also vague regarding disclosure best practices (e.g., disclosing on the face of the Statement of Financial Position (SOFP) versus disclosing as a footnote). For the CDFI industry, the Performance Counts working group recommends the following:

- **Restricted:** On the face of the SOFP, only cash that is restricted as to use by a formal agreement providing direct access to that cash to a third party (whether held or not held by a third party) should be disaggregated and presented separate from unrestricted cash and cash equivalents. Examples of this include:
 - Amounts deposited in escrow or for a specified purpose subject to release only at the order of an organization other than the depositor.
 - Property tax monies collected for borrowers and held in escrow by the CDFI.
 - Funds required to be held in a restricted account such as required cash collateral. For example, the CDFI Fund Bond Guarantee Program requires CDFIs to hold cash for a 3% Risk Share Pool. The Risk Share Pool funds are held in a trust account by the Master Servicer/Trustee of the Bond, and should be included in “restricted cash”.

In addition, if the CDFI has cash of material amounts that is restricted by a third party (e.g., cash required by a third party to be set aside and restricted to cover losses or investor repayments in a particular program), this cash should also be disaggregated on the SOFP as restricted cash.

The audit report should also include a detailed footnote outlining composition and purpose of such restricted cash. Should the CDFI have small amounts of restricted cash, determined not to be a material amount, they do not have to disaggregate this cash on the SOFP but still should disclose this purpose and composition of this cash in the notes to its financial statements.

- **Limited in Use:** CDFIs also have cash, cash equivalents, and investments that have donor or contract-imposed limitations on use but remain in the sole control of the CDFI (e.g., cash to be used for programmatic operating purposes or for future financing). For such cash, cash equivalents or investments, the CDFI should disclose the nature, composition, and amount of this cash in the notes to financial statements but not on the face of the SOFP.



Below is an example of potential disclosure note related to cash and cash equivalents.

At December 31, 2014 and December 31, 2013, CDFI XYZ had \$2,800,000 and \$2,200,000, respectively, of cash and cash equivalents. Of these totals, \$1,100,000 and \$1,100,000 were restricted (held in an escrow account or another account for a third party) and \$1,200,000 and \$600,000 were limited in use by grants, investment agreements, and contracts at December 31, 2014 and December 31, 2013, respectively. The remaining funds were unrestricted.

	2014	2013
Unrestricted	\$500,000	\$500,000
Restricted		
Escrow Payable and Due to Third Parties	\$800,000	\$800,000
Risk Share Pool: Bond Guarantee Program	\$300,000	\$300,000
Limited in Use		
Operating	\$200,000	\$100,000
Financing and/or Investor Repayments	\$1,000,000	\$500,000
Total Cash and Cash Equivalents	\$2,800,000	\$2,200,000

Similar to cash and cash equivalents, Performance Counts recommends that CDFIs should include a note to the financial statements that segregates investments into unrestricted, restricted, and limited in use. CDFIs typically have the option to keep liquid assets in cash or cash equivalents, or invest in marketable securities to diversify or earn a higher return. Therefore, it is important to understand the underlying limitations on these investments (in addition to cash and cash equivalents). However, the CDFI may also have certain investments that are programmatic in nature (e.g., equity investment in businesses, real estate holdings classified as investments). These investments can be excluded from this disclosure.

V. LIQUIDITY MANAGEMENT PRACTICES

CDFIs use a variety of methods, tools, practices, policies, and ratios to help manage their liquidity. They must manage both short-term and long-term liquidity to ensure sufficient cash to fund operating expenses and loan pipeline, as well as repay debt to investors maturing in the near term. CDFIs must find the appropriate balance between maintaining sufficient available cash and investing all cash, as there is a cost to holding cash that is not deployed as an earning asset. The section below discusses several liquidity management practices employed in the industry and the considerations for using the different practices. Each CDFI needs to develop and adopt an optimal set of liquidity practices that work best for itself, its investors, borrowers, and board of directors.

Liquidity Ratios and Covenants

CDFIs should monitor and manage operating and capital liquidity separately but in tandem.

- Operating liquidity is defined as the availability of liquid assets to fund operating expenses of the organization.
- Capital liquidity is the availability of liquid assets to fund loans and investments and to repay investors.

Operating and capital liquidity focus on different areas of the SOFP. Operating liquidity focuses on assets (maintaining a specific level of cash and investments) to cover operating expenses whereas capital liquidity focuses on both assets and liabilities (repayment to investors and sufficient levels to sustain or grow loan portfolio). Most CDFIs have separate minimum operating and capital liquidity requirements (or reserves), but some CDFIs maintain only one combined pool of assets for operating and capital liquidity.

There are a variety of ratios CDFIs use to help monitor and manage operating and capital liquidity. Table 2 outlines the four most common ratios, the CDFI industry definitions, and recommended benchmarks.



Investors often incorporate liquidity covenants in the loan agreements with their CDFI borrowers. The Performance Counts working group believes the **Operating Liquidity Ratio** and **Capital Liquidity Ratio** are the two best ratios to covenant in loan documents for this purpose. Below is a table of ratio definitions followed by a discussion of additional considerations to review on liquidity ratios.

Table 2. Liquidity Ratios

	Operating Liquidity Ratio				Current Ratio	Quick Ratio	Capital Liquidity Ratio
CDFI Industry Ratio	Unrestricted Cash & Cash Equivalents	+	Cash & Cash Equivalents Restricted for Operations*	X 12	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{\text{Liquid Assets} + \text{Current Loans Receivables}}{\text{Current Liabilities}}$	$\frac{\text{Liquid Assets} + \text{Specific \% of Current Loans Receivable}}{\text{Current Investor Notes Payable}}$
	Total Expenses Prior Fiscal Year	–	Non-cash** Expenses				
Comment	Represents months of operating cash				Current Ratio is not considered the best measurement as may include assets that are not liquid.	Quick Ratio is a more traditional measure of liquidity using only the most liquid of current assets.	Capital Liquidity Ratio captures short term investor debt that can possibly be repaid with available liquid capital.
Benchmark	>3 months				Ratio>1.2	Ratio>1.0	Ratio>1.0

* include non-lending programmatic activity

** Non-cash expenses could include depreciation and allowance for loan losses.

Operating Liquidity Ratio

The CDFI industry traditionally uses an Operating Liquidity Ratio to objectively measure sufficiency in operating liquidity. While there are a number of small variances in the ratio's definition, the above definition is the most frequently used definition.

The measurement of “months of operating cash” or “months coverage” can be viewed as contingency funding in the case of a crisis. Excluding unique circumstances, Performance Counts recommends CDFIs maintain an absolute minimum operating liquidity equal to 3 months (90 days). While most CDFIs' minimum is 3 months, many CDFIs have a goal to maintain a level between 3 to 6 months.

Many CDFIs establish a policy regarding the minimal amount of operating reserve that is equal to a specific dollar amount or number of months. There are a few factors that CDFIs may want to consider in setting their operating liquidity benchmark:

- **Dependency on inconsistent revenues:** If a CDFI is heavily reliant on grants or other sources of revenue that are not predictable (e.g., origination fees for New Markets Tax Credit), the CDFI may want to have higher operating liquidity because these sources of revenue could be in jeopardy in a given year, and the CDFI may not be able to reduce expenses in response to shortfalls in revenue.
- **Availability of Lines of Credit:** CDFIs that keep availability on unrestricted lines of credit may take into consideration the availability of this funding source.
- **External Factors:** CDFIs should consider a downturn in the economy or change in regulation that may significantly increase an organization's credit risk. When portfolio credit risk increases, a CDFI must be ready for interest income to decrease.

Capital Liquidity Ratio

The most important factor in measuring capital liquidity is the availability of cash to repay investors. While it is hard to find one ratio to capture the concept of capital liquidity, the Performance Counts working group believes the Capital Liquidity Ratio is the best metric to capture the CDFIs ability to meet its short-term (or current) investor obligations.

The following are factors that should be considered when developing and calculating a CDFI's specific Capital Liquidity Ratio:

- **Current Loans Receivable:** The numerator of the Capital Liquidity Ratio includes a specific percentage of current loans receivable as CDFIs can use these loan repayments to repay investors. The percentage of current loans receivable that CDFIs include in the Capital Liquidity Ratio typically ranges from 50 percent to 80 percent and depends on a number of factors including historical loan pay off rates at maturity. For example, a CDFI may include a higher amount of current loans receivable in its calculation if a majority of its loan portfolio fully amortizes or, in the case of short term loans with large balloon payments³ such as construction loans, the CDFI has a proven track record of reliable take out sources at maturity. A CDFI may use a lesser percentage of loans receivable in the Capital Liquidity Ratio when it has a practice of renewing a large percentage of its balloon loans. The CDFI should analyze historical data on the pay-off rates of maturing loans to justify the percentage used in the calculation.
- **Current Investor Notes Payable:** The reason the denominator does not include other current payables is that, for the majority of CDFIs, the current investor notes payable is the most significant current liability on the SOFP. Additionally, other major categories of current liabilities such as accounts payable and accrued expenses are normally paid off through the current period income. If that is not the case for a particular CDFI, the CDFI can consider including other payables in the denominator.

Capital Liquidity Reserve

A complimentary approach to ensuring appropriate capital liquidity is for CDFIs to establish a capital liquidity reserve. A capital liquidity ratio may indeed be used in loan covenants to measure a minimum required liquidity level; however, a capital liquidity reserve can be more finely tuned for use by a CDFI to ensure it has sufficient funding available to support investor repayments based upon the historical performance and renewal behavior of investor liabilities.

³ A balloon loan does not fully amortize over the term of the loan and, thus, results in one large final principal payment (balloon payment).



Capital Liquidity Examples

Example 1

One CDFI maintains two types of capital liquidity reserves: a short-term reserve equal to current debt liabilities maturing within 180 days and a long-term reserve equal to 7.5 percent of its primary core financing fund's debt liabilities (including equity equivalent investments⁴). The short-term capital liquidity reserve is maintained in cash, while its long-term reserve is maintained in a combination of cash and cash equivalents, but primarily marketable securities.

Example 2

Another CDFI maintains a capital liquidity reserve of 10 percent of all outstanding financing debt (excluding equity equivalent investments). The reason the CDFI maintains a sizable capital liquidity reserve is to mitigate the risk associated with any potential asset liability mismatch.

Example 3

A large CDFI maintains \$10 million in unrestricted cash and cash equivalents to cover both operating and capital liquidity and as a liquidity reserve for covenant calculations. While the CDFI does have lines of credit available to fund loans, the access to the lines may be delayed while appropriate documentation is completed. Therefore, the CDFI chooses to have a reserve with sufficient monies to fund one or two loans, if needed.

Example 4

Another CDFI maintains \$2.5 million in an unrestricted cash account to satisfy unanticipated draw requests from borrowers under committed but undrawn credit facilities. \$2.5 million is based on an average historic draw size and frequency of requests.

Cash Flow Projections

To ensure sufficient capital and operating funds are available, a CDFI needs to be able to project as accurately as possible the organization's cash inflows and outflows on a periodic basis. Cash flow projections are used to understand short-term funding needs, as well as for long-term strategic business planning. This is the primary tool CDFIs use to monitor and manage liquidity, both operating and capital. For both short- and long-term planning, the cash flow projections should be:

- Detailed and realistic, capturing all sources and uses of liquidity including off-balance sheet sources (albeit separated, particularly if off-balance sheet activity does not impact on-balance sheet cash positions).
- Updated and reviewed on a regular basis (frequency is dependent on a CDFI's respective cash flow activity).
- Developed with information gathered from the following departments:
 - Lending: Information regarding projected loan repayment schedules and loan disbursement schedules, including renewed loans and committed but undrawn loan facilities.
 - Funding: Projected outflows related to maturing investor debt liabilities, plus undrawn debt liability commitments, including available funding lines of credit⁵.

⁴ Equity Equivalent investments, commonly referred to as EQ2, are investments that are general recourse, subordinated debt with no covenants, very limited callable conditions, and that have an indeterminate maturity.

⁵ Some CDFIs have secured investor financing facilities that require specific types of acceptable collateral pledged as security; therefore, the cash flow projection can sometimes be further complicated as the CDFI must ensure it has appropriate collateral types to pledge when financing new loans with secured investor debt (e.g., Federal Home Loan Bank and the CDFI Fund Bond Guarantee Program borrowing facilities)



- Development: New donations, grants or other funding sources.
 - Accounting/Finance: Other cash commitments and important payables, inclusive of any new high-dollar capital expenditures such as purchase of a building, or new IT equipment.
 - Program Teams: Other program-related cash and expenditure commitments (e.g., training, conferences, pass-through grants)
- Back-tested on a regular basis to understand if assumptions (such as the dollar amount of commitments funded) were correct.

The majority of CDFIs use Excel spreadsheets to develop their cash flow projections. As the industry gets more sophisticated, CDFIs may need automated cash flow projection models that feed directly from their accounting and loan administration software to receive direct income statement/balance sheet inflows and outflows data.

Cash Flow Projection Frequency

For short-term liquidity needs, the majority of CDFIs use 30- to 90-day forecasts that are updated on a monthly basis, as these time frames allow the CDFI to have ample time to understand any capital needs/shortfalls. This frequency can be extended if a CDFI employs additional cash liquidity reserves to handle short-term funding needs.

For longer-term planning, CDFIs use cash flow projections of 1 to 5 years (sometimes out to 10 years) that incorporate projected loan portfolio growth, large capital investments or other large cash flow events.

Asset-Liability Management

Cash flow projections go hand-in-hand with asset liability management. Asset-liability management is the practice of managing various risks that arise from a variety of potential mismatches between the assets and liabilities. In conjunction with cash flow projections, a CDFI often performs a gap analysis (either by maturity or by interest rate structure), as part of asset-liability management, in order to identify any important “gaps” or “mismatches” in various maturity buckets (e.g., 1 year, 3 years, 5 years, 7 years). For instance, if a CDFI has a 1-year asset with a value of \$1 million and a 1-year liability worth \$3 million, the CDFI has a negative 1-year “gap” of \$2 million. In other words, absent a behavioral analysis of these two items, the CDFI has insufficient maturing assets within 1-year to meet its larger liability repayment needs. Historically, many CDFIs, especially those lending against real estate assets, have assets that behave more like longer-term assets (matching the stated useful life of the underlying financed assets) but have liabilities that are shorter-term in nature. Over time, the magnitude and location of these maturity gaps may change given the timing of new and renewed assets and liabilities, as well as changes in economic conditions. While a CDFI may attempt to “match” its assets and liabilities with borrower maturity call provisions or rate reset provisions, a CDFI should always prepare a regular gap analyses to help understand current risks and plan appropriate mitigation strategies.

Saying this, some CDFIs may intentionally run asset-liability mismatches in a particular maturity bucket to potentially profit from certain interest rate environments, or to reposition its balance sheet when it introduces different lending products—such a practice is not recommended without strong risk management review systems and procedures in place.

As CDFIs gain access to longer-term capital (up to 30 years) under the Federal Home Loan Bank program and the CDFI Fund Bond Guarantee Program, on both a fixed rate and floating rate basis, asset-liability management and long-term capital liquidity management becomes even more important. Increasingly, not only must CDFIs analyze maturity gaps between assets and liabilities and understand their true behavior (despite stated maturity dates), they also must understand the interest rate risks and potential impacts on profitability caused by these factors.



Cash Flow Projection Examples

Example 1

A CDFI provides loan products that encompass predevelopment, acquisition, construction, and mini-perm loans, with terms ranging from 12 to 72 months.

This CDFI maintains three versions of its capital liquidity forecast—a rolling short term cash flow forecast that focuses on capital requirements for the next 45 days, a rolling medium term forecast that focuses on loan capital requirements for the next 180 days, and a long term forecast that addresses loan liquidity requirements for the next two to three years. All three of these forecasts address both projected loan disbursements and loan repayments, and, as a consequence, the CDFI's capital liquidity requirements.

The 45-day forecast focuses on loan applications that have been approved by the loan committee and have an assigned closing date or a fairly accurate estimate of one. The 45 day forecast also takes into consideration loan repayments that will be coming due within that timeframe. The loan administration team is generally in conversation with those borrowers who are scheduled to repay their loans. These practices lead to a highly accurate short-term forecast.

The CDFI uses both lines of credit and term loans to fund its loan portfolio. Needed funds can be drawn from the lines on five days' notice, which serves to minimize interest expense. Excess liquidity can be used to pay down credit lines, or be invested. Investments can be liquidated with two days' notice.

The 185-day forecast is similar to the 45-day forecast, but draws on inferences about the CDFI's active pipeline of those loans that have not yet been approved by the loan committee, as well as projected repayments. It is somewhat less accurate, but serves to ensure that needed liquidity will be in place when loan applications in this category move to the shorter 45-day forecast.

Its longer-term forecasts are made by its Community Investment Team, based on its knowledge of lender capacity, average loan size, and any geographic expansion anticipated by the CDFI's current strategic plan. The forecast distribution of these loans over time is based on its historic monthly distribution averages. These long-range forecasts serve as planning tools and are used as guides when thinking about either expanding its relationships with existing loan fund investors or seeking new investment partners.

Example 2

A CDFI monitors maturities and renewals closely when setting the organization's capital raising goals at budget time. The organization uses short-term (6 month) and long-term (5 and 10 year) cash flow planning models (in Excel). In the models, the CDFI includes "known" repayment requirements to investors into the cash flow planning, and applies a discount to recent historical average renewal rate for any "unknown" investment maturities. Based on its historical data, the CDFI assumes that 85 percent of its investments will renew.

Example 3

A CDFI updates its lending capital liquidity model on a monthly basis, which is an advanced Excel model comparing projected assets and liabilities. It is a rolling 18-24 month forward look (with the capability of extending further if needed for such events as five year strategic planning). The CDFI does not have a separate liquidity process for operational cash flow needs.



Example 4

A CDFI developed a one-page Excel liquidity forecast that succinctly presents 30 and 90 day liquidity levels, as of a specific date. The forecast provides on-balance sheet liquidity and total available liquidity, which is inclusive of available off-balance funding sources such as projected loan sales, available capital, or guaranteed portions of loans available for sale.

As part of the CDFI's annual budget process, lending commitment goals are discounted by 25 percent to obtain a projected disbursement amount which feeds into the cash flow projection. The 25 percent discount is supported by multi-year historical data on commitments that ultimately don't close, as well as construction loans or lines of credit that don't end up fully drawn.

Sensitivity Analysis

A sensitivity analysis reports on the range of possible financial outcomes, as specific assumptions are purposely varied (e.g., changes in a lending and funding portfolio, financial projections, and/or related cash flow projections). A CDFI may choose to “stress” certain asset durations or model extreme interest rate scenarios in its cash flow projections, in order to better understand how its financial performance and liquidity levels would be affected. Two commonly performed types of sensitivity analyses are a waterfall analysis and an interest rate analysis, as described below.

Waterfall Analysis: This sensitivity analysis modifies an organization's cash flow projections under various scenarios. Sample variations on a baseline cash flow projection are the following:

- Behavioral maturity analysis adjusts contractual maturity dates of larger assets and liabilities to perform differently than stated maturity dates. For example, a CDFI may have a funding liability with a short term maturity date (12 months) but, based on history, the investor always renews the note payable, and therefore is considered a long-term liability in the revised waterfall scenario.
- Modified behavioral analysis also may modify cash flow to include a number of non-historical repayment actions, including but not limited to:
 - 1) Extending loans with large balloon payments (i.e., mini-perm loan facilities): Assume that a few larger borrowers with balloon payments will not receive take-out financing.
 - 2) Repayment of investor notes at maturity repayment: Assume a few investors request repayment at maturity instead of renewing the debt due to perceived changes in the CDFI investor landscape.
 - 3) Worst case scenarios may be employed to help understand when a CDFI would run out of cash if its assets repay longer than expected and its liabilities are repaid faster than historically repaid.

Waterfall Analysis Examples

Example 1

A CDFI conducts a “worst case scenario” waterfall analysis to understand when the CDFI would run out of cash if no loans receivable repay and all investors are repaid. It was during the most recent economic downturn that the CDFI's board of directors requested that a worst case scenario waterfall analysis be completed on a quarterly basis.

Example 2

Another CDFI will run worst case scenarios on an as-needed basis. For example, this scenario may assume no new closings for the next 12 months to make sure that the CDFI is sufficiently capitalized to meet all its existing commitments. Generally, the cash flow models err on the conservative side, where management makes educated assumptions around bullet maturity repayments, debt roll overs, and the timing of new loans.



Interest Rate Sensitivity Analysis: The goal of this specific stress test or alternative interest rate scenario analysis is to understand how changes in interest rates on CDFI's loan assets or liabilities may impact a CDFI's financial situation. Unlike banks and credit unions, non-depository financial institutions have not typically employed sophisticated risk management methodologies such as interest rate shock simulation analysis. While CDFI banks and credit unions are required to conduct a variety of interest rate sensitivities analyses, more loan funds are conducting these types of analyses as their capital structures become more complex. The most common interest rate sensitivity analyses are forward-looking "rate shock" scenarios that report the financial effects of increasing or decreasing interest rates by a prescribed number of basis points. For example, one scenario could proactively stresses net interest margin (NIM), by decreasing lending asset interest rates by 100 to 400 basis points.

Traditionally, CDFI loan funds have tried to match-fund their balance sheets (matching assets and liabilities with similar, fixed-rate interest rate structures), such that the only shock to interest rates or profitability would occur if the CDFI had significant maturity mismatches between its loan asset and funding liability structure. As CDFIs expand both short-term and long-term lending and gain access to floating-rate and longer-term funding sources, CDFIs will need to spend more time analyzing interest rate risk due to mismatches in both maturity and interest structure.

Interest Rate Sensitivity Examples

Example 1

One CDFI uses an in-house interest rate sensitivity tool to shock interest rates under various scenarios during its annual budget planning process. As a significant portion of the CDFI's loans receivable and debt have fixed rates and are matched by duration, management feels an annual analysis is sufficient to estimate the amount of risk offered by interest rate increases or decreases. The most recent shock analyses completed for their current budget showed that a 100 basis point increase or decrease in market interest rates would have little impact on the CDFI's budgeted net interest income. The CDFI's management did note that in a rising interest rate environment, their rate shock analysis may be reviewed more frequently.

Example 2

Another CDFI with a balance sheet consisting of both fixed and variable rate capital and loans receivables actively monitors its interest rate risk. Originally, the CDFI used Smith Breeden and Associates, a nationally-recognized asset liability management modeling and money management firm, to help model its interest rate risk and advise it on risk mitigation strategies.

In more recent years, the CDFI purchased ZM Desk, a leading ALM software tool. One full-time employee operates the software for both the non-depository CDFI and its two affiliated CDFI credit unions, by modeling different interest rate scenarios so that management and the board of directors can be aware of, and mitigate, interest rate risk. The CDFI and its affiliated credit unions use a third-party vendor, ALM First, to periodically assess its assumptions and model inputs to ensure that the model is adequately measuring and modeling interest rate risk.

The CDFI's Asset Liability Management Policy states that on a quarterly basis the Board will receive an interest rate management report that stress tests the market value of the organization's net worth under decreasing market interest rates by intervals of 100, 200, and 300 basis points. The policy states management will match fund or hedge such that a 300 basis point increase or decrease would not reduce the market value of the CDFI's net assets below 12 percent of total assets or reduce the market value of net assets by more than 35 percent.



Additional Liquidity and Capital Management Tools and Considerations

In addition to the tools mentioned above, a CDFI should have a variety of complementary liquidity tools at its disposal to manage and maintain its capital liquidity. Some of these additional practices and tools are shared below:

- **Back-up Lines of Credit (LOCs):** In general, CDFIs may use LOCs to meet short-term operating and capital funding needs, particularly if the LOC has no limiting use restrictions. A CDFI will need to decide if the associated costs of maintaining such a reserve liquidity line are warranted (costs may include closing costs and non-usage fees). Realistic cash flow projections should allow an organization to understand if the CDFI needs a LOC and the amount needed to meet potential cash shortfalls or tight liquidity. Some CDFIs choose to maintain a backup LOC facility, even if not planning usage so that the organization has readily available backup liquidity. LOCs can be from banks, the Federal Home Loan Bank, or other sources. However, it is important to factor non-usage fees into this option.
- **Loan Sales and Risk Participations:** Though more frequently used as a credit risk mitigation tool, some CDFIs increasingly use loan sales and risk participations to provide liquidity at times when new capital access is constrained.

In addition to the liquidity tools discussed above, CDFIs often implement other ratios and practice guidelines to help monitor and manage liquidity and its impact on their financial statements. Some of the more common practices include:

- **Deployment Ratios:** This ratio presents an overview of the percentage of funds that are deployed (“at work”) as loans/investments in the communities CDFIs serve. (The inverse of the deployment ratio is the percentage of funds available to lend). There are a few different definitions for the deployment ratio used in the industry, with the most common as following:

$$\text{Deployment Ratio} = \text{Gross Loans Outstanding}^6 \div (\text{Net Assets Available for Lending} + \text{Debt for Financing})$$

A typical deployment ratio for CDFIs ranges from 65 to 90 percent depending on a number of different factors. CDFIs may establish internal minimum deployment levels.

- **Over-Commitment Ratios:** Some CDFIs have specific internal guidelines and/or management policies that allow for the CDFI to over-commit its available capital funds, meaning that the organization would commit in excess of 100 percent of funds that are available (if loan commitments are included in the numerator). This is a legitimate liquidity management practice used by CDFIs that are able to forecast with a good amount of certainty the dollar amount of loan commitments that will not cycle into actual disbursed loans and the dollar amount of early loan repayments. If management believes that the historical information is a good indicator of future trends, they may get comfortable with over-committing capital up to a certain percentage.
- **Interest Rate Ceilings and Floors:** Some CDFIs limit the variable interest rate risk on their balance sheet by placing either “rate ceiling” clauses in investor notes (limiting the increase in their cost of borrowing) or “rate floor” clauses in notes receivable (limiting the decrease in the rates extended to their borrowers).

⁶ Sometimes CDFIs include loan commitments and capital commitments not yet advanced in the numerator and denominator, as these commitments may count as deployed.



Policies

While many of the elements included in a CDFI's liquidity management practices are documented in guidelines, procedures, or other internal documents, there are certain elements that may be appropriate to include in policies that are approved by the Board.

No CDFI should invest any of its liquidity in marketable securities without a clearly articulated policy guiding the parameters of those investments—typically, called an Investment and Cash Management Policy. Such a policy provides outlines the selection criteria, mission review, and active management of investments and cash management products, in order to ensure the safety and liquidity of investments. Topics covered in such a policy include: authority levels, types of investments allowed, mission screen criteria, asset allocation limits, and minimum credit quality of investments, as well as by whom and when the investment portfolio is reviewed.

A CDFI may incorporate other elements of its liquidity practices into its Investment and Cash Management Policies or Financial Risk Policy such as minimum levels of capital and operating reserves or maximum over-commitment levels.

Investment Policies Examples

Example 1

One CDFI has a Board-approved Investment and Cash Management Policy⁷ that describes the key criteria the CDFI considers in selecting how to invest its cash and investments as follows:

- Preserve the CDFI's capital through diversification and limitation on investment type
- Apply positive and negative screening techniques to ensure investments are consistent with mission
- Comply with all investor intentions and covenants
- Maximize return
- Invest in Member CDFI debt instruments where prudent
- Preserve financial independence through competitive selection of institutions
- Minimum credit worthiness of investments and marketable securities
- Minimum operating liquidity reserve of three months of projected operating expenses (excluding provisions for loan losses) with a target range of six months

Example 2

Another CDFI has an Investment Policy approved annually by the Board of Director's Finance Committee. The policy provides guideline on the investment portfolio of the following areas:

- Assets allocation
- Duration of the securities
- Percentage of the portfolio by type of security
- Percentage of the portfolio by issuer

The policy states in which financial instruments management can invest and the maximum percentage of the specific instrument (of the total investment portfolio). For example, the policy states that prime commercial paper rate A1/P1 or higher cannot be more than 50 percent of total investments.

⁷ A copy of sample Investment and Cash Management Policies are available for review on OFN's online community for CFOs and Finance Professionals.

Reporting and Oversight

The overall responsibility for liquidity management is multi-layered. A CDFI's finance team typically has primary responsibility for monitoring, controlling, and measuring liquidity. A CDFI should also have a board or senior management committee to discuss overall risks associated with CDFI liquidity and to review appropriate practices, reports, and policies. For some CDFIs, these responsibilities fall to their Board's Finance and Audit Committee, while other CDFIs have a separate risk committee to consider these issues. CDFI banks and credit unions typically have separate Asset Liability Management Committees (ALCOs), although such a committee is becoming a more common practice among larger CDFI loan funds.

The typical responsibilities of an oversight committee related to liquidity practices include:

- Monitor liquidity practices, levels, and ratios
- Monitor asset liability management
- Opine on pricing of assets and liabilities
- Monitor investment portfolio results and practices
- Review asset and liability gap analysis reports and interest rate sensitivity shock reports
- Recommend appropriate policy or practice changes based on these reviews

An oversight committee typically meets a few times per year to review some or all of the above reports. The frequency and type of reporting will depend on the CDFI's sophistication and complexity of liquidity management practices and the economic environment. For example, in an environment of substantial fluctuations in interest rates, CDFIs may need to review certain reports more frequently.

ALCO Committee Example

A CDFI formed an organization-level ALCO in 2015 in order to better manage its SOFP with a focus on long-term viability in the event of adverse interest rate changes. The ALCO members are the chief executive officer, chief risk officer, chief lending officer, chief financial officer, and director of finance. The ALCO committee meets on a quarterly basis to monitor and manage any long-term asset liability mismatch. The CDFI's staff will report on:

- Notes payable and loans receivable and highlight any periods in which maturing liabilities are greater than maturing loans receivable and other assets by greater than \$10 million.
- Net interest margin simulation analysis. Acceptable limit: Net income margin should not decrease more than 10 percent given a 200 basis point interest rate shock increase on adjustable rate debt and any new notes payable for each of year 1 and year 2 of the most recent projections.

The Chief Financial Officer is also responsible for reporting asset liability metrics to the Board's Audit and Finance Committee. The report should include any action by the ALCO and highlight any non-compliance with the above requirements.



VI. CONCLUSION

With the growing complexity of CDFI balance sheets and the increasing array of new financial products and capital sources, CDFIs must continually evolve their risk management strategies, particularly around operating and capital liquidity. Given the richness and diversity within the CDFI industry, there is no simple “one size fits all” set of metrics or tools to unilaterally employ; however, the practices and guidance discussed in this paper provide a solid general framework by which to examine and analyze the unique needs at your CDFI. The Performance Counts Working Group encourages all CDFIs to review the various tools, practices, and guidance discussed in this paper and determine how best to implement the recommendations shared.

SUMMARY OF PERFORMANCE COUNTS WORKING GROUP RECOMMENDATIONS

While a majority of this paper is a discussion of liquidity and cash management practices, we have included recommendations on a few key topics related to liquidity and cash management. Below is a summary of the significant Working Group recommendations incorporated into this paper related to liquidity:

- CDFIs should include financial statement disclosures on limitations and restrictions on the use of cash, cash equivalents, and marketable securities.
- The Operating Liquidity Ratio and Capital Liquidity Ratio are the best two ratios for investors to use as covenants related to liquidity.
- All CDFIs should have a dynamic cash flow projection updated frequently with input from the lending and finance teams to help manage liquidity.
- CDFIs should establish a board or senior management team to monitor liquidity practices and results.

The Working Group will publish papers on additional topics in the future. Over time, we expect this effort to benefit the industry overall by improving financial management and making it easier for funders, investors, and other key stakeholders to understand the industry’s financial statements and financial wherewithal—and to ultimately lead to new sources of capital and resources for the CDFI industry.



APPENDIX A

Performance Counts Working Group and Advisors

OFN would like to thank the following CDFIs for their participation in the Working Group. One or more individuals from these organizations met to review the issues and arrive at the recommendations and guidance presented in this paper. These recommendations are endorsed by the Working Group members

Working Group

Capital Impact Partners
Chicago Community Loan Fund
Corporation for Supportive Housing
Craft3
Fahe
Low Income Investment Fund
New Hampshire Community Loan Fund
New Jersey Community Loan Fund
Northern California Community Loan Fund
Opportunity Finance Network
The Progress Fund
The Reinvestment Fund
Self-Help Ventures Fund

Additionally, a number of experts provided accounting advice and guidance to the Working Group to ensure that the information and recommendations presented in this paper are compliant with GAAP and other accounting guidance.

Accounting Advisors

Alexander, Aronson, Finning & Company
CohnReznick LLP
Novogradac & Company LLP

OFN is coordinating with Aeris to ensure that this effort is complementary to the data collection platform that Aeris has developed.

The Working Group also received input from many other CDFIs, CDFI funders and investors, and industry advisors. OFN appreciates the feedback from these various parties, which contributed to the final paper content.

Finally, the Working Group would like to thank consultant Donna Nails for her contribution to the paper.



APPENDIX B

Accounting Guidance on Issues Related to Liquidity and Cash Management

Appendix B includes guidance from the Audit & Accounting Guide (A&A Guide) related to treatment and disclosures related to Cash and Cash Equivalents.

Excerpted from A&A Guide

Cash and Cash Equivalents

4.79 A statement of financial position should include a separate line item for “Cash” or “Cash and Cash Equivalents.” As noted in paragraphs 3.09–.23, cash and cash equivalents received with donor-imposed stipulations restricting the use of the cash contributed to long-term purposes and cash set aside for long-term purposes should not be classified on a statement of financial position with assets that are available for current use. As noted in paragraph 3.09, Not For Profit entities (NFPs) are required to provide information about liquidity or maturity of assets and liabilities, including restriction on the use of particular items.

4.80 Some limitations may exist on an NFP’s ability to withdraw or use cash and cash equivalents. These limitations may be imposed by (a) creditors and other outside parties (such as limitations on cash held by financial institutions to meet compensating balance requirements, cash and cash equivalents held as collateral on debt obligations, cash received as collateral on loaned securities, and cash held for students, clients, and others under agency agreements); (b) donors, who place restrictions on their cash contributions (such as restricting the contributions to investments in buildings or creation of endowments, as described in paragraph 4.03); or (c) governing boards, which may designate cash for investment purposes (traditionally known as “funds functioning as endowment” or “quasi endowment”). NFPs are permitted, but not required, to disaggregate assets into unrestricted and donor-restricted classes when there are donor restrictions on the use of specific donated assets. Paragraphs 3.09–.23 discuss reporting similar limitations on assets other than cash.

4.81 FASB ASC 958-210-45-7 requires that relevant information about the nature and amount of limitations on the use of cash and cash equivalents (such as cash held on deposit as a compensating balance) be included on the face of the financial statements or in the notes. Information about the nature and amount of donor-imposed restrictions should also be disclosed in the net asset section of the statement of financial position or in the notes to the financial statements. (Chapter 11, “Net Assets and Reclassifications of Net Assets,” discusses accounting for net assets.) FASB ASC 958-210-50-2 requires disclosure in the notes to the financial statements if unusual circumstances (such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems) are present, or if the NFP has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions. (Paragraphs 3.173–.175 discuss reporting requirements if an NFP is not in compliance with donor-imposed restrictions.)

4.82 Q&A sections 2130.38–.40 (AICPA, Technical Questions and Answers) discuss the classification of certificates of deposit on the statement of financial position and whether certificates of deposit are debt securities that must be recognized at fair value. Certificates of deposit with original maturities of 90 days or less are commonly considered “cash and cash equivalents” under FASB ASC 305, Cash and Cash Equivalents. A certificate of deposit with an original maturity greater than 90 days would not be included in cash and cash equivalents. Certificates of deposit generally are not debt securities as defined in FASB ASC 958-320. However, some negotiable certificates of deposit may meet the definition of a security. Certificates of deposit that are not debt securities are “other investments,” as discussed in paragraph 4.37 of this guide.



NOTES

[illegible]

NOTES

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For more information on Performance Counts:
<http://ofn.org/performance-counts>



PERFORMANCE COUNTS
Best Practices for CDFI Financial Statements and Management