

Risky Business

BY RON JOHNSTON

Community development corporations (CDCs), whether they know it or not, are in the business of risk management. The word “risk” originates from the Italian word *risicare*, meaning “to dare.” That is what CDCs do; they dare to invest in neighborhoods, in properties and in individuals that other investors routinely reject, ignore or exclude, based on risk.

While it is hard to dispute that community development often involves a great deal of risk, a lot of nonprofit CDCs have not established anything approaching a deliberate, dedicated process to assess, categorize and manage risk on either a project basis or the organization as a whole. The lack of preparedness can disable or even permanently sink an organization. Therefore, community development organizations must pay greater attention to the business of risk management.

No organization sets out to fail, yet by not preparing for certain predictable events, some organizations do, despite their best intentions, stumble into failure. By identifying what is an acceptable level of risk, and having the capacity to manage it, organizations are more likely to sustain their presence and build capacity to serve their communities.

Illustration by Filip Yip





What Are the Risks?

The Nonprofit Risk Management Center refers to risk as “any uncertainty about a future event that threatens your organization’s ability to accomplish its mission.” Likewise, the Subcommittee and Working Group on Risk Management Principles of the Financial Services Roundtable defines risk as “the potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organization’s ability to meet its business objectives.”

A risk is any threat to an organization’s ability to carry out its mission, sustain one or more of its operations, and maintain or enhance its reputation.

Conventional banks are in the business of being compensated for taking limited risks. According to a report from the Financial Services Roundtable, banks’ goals are to ensure that:

- ▶ Risks are understood;
- ▶ Risks are within tolerances established by the board of directors;
- ▶ Risk-taking decisions are consistent with strategic business objectives;
- ▶ Risk-taking decisions are explicit and clear;
- ▶ The expected return compensates for the risk taken;
- ▶ Capital allocation is consistent with risk exposure; and
- ▶ A bank’s performance incentives are aligned with risk tolerances.

These same goals could easily be adapted to CDCs, community development financial institutions (CDFIs) and other special-purpose lenders, such as many NeighborWorks® organizations—noting, again, that the goal is not to eliminate risks but to be prepared for and properly account for them.

What Are Acceptable Levels of Risk?

Neighborhood Reinvestment views risk management as “a discipline for dealing with the possibility that a future event will cause harm.”

The first thing to make clear is that these events can and do occur at any time—to any and all organizations. They can include, for example, the departure or poor performance of key personnel (sudden loss of funding); sudden loss of fee-generated income; unforeseen start-up costs for a new project or program; or economic, regulatory or political changes that impact the organization. All these and more can affect organizational balance sheets and the

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ability to meet objectives—whether the organization is General Motors or an inner-city CDC.

That these risks do occur should not lead to negative conclusions regarding program performance. It is the measure of the level of risk being taken versus the organizational capacity to bear that risk that is the critical relationship.

One of the chief attributes of the NeighborWorks® system is the risk-management oversight of individual network organizations by Neighborhood Reinvestment. Neighborhood Reinvestment relies on both on-site and off-site assessments to determine the risk-versus-capacity relationship. It attempts to provide meaningful and continuous information to the leadership of individual organizations, as well as to stakeholders. Neighborhood Reinvestment relies on an ongoing flow of current financial and programmatic data from each organization—much of it self-reported—to conduct its risk/capacity analysis.

Identification, Analysis, Mitigation

Neighborhood Reinvestment’s risk-assessment model is predicated on three major categories: risk identification, risk analysis and risk mitigation. These areas are often interrelated and generally interdependent. That is, upon identifying inordinate risk Neighborhood Reinvestment seeks to provide detailed analysis as a basis for an intervention or mitigation strategy.

A clear example is in the area of loan-loss reserves. Many of our NeighborWorks® organizations have, over the years, accumulated a fairly large and diverse portfolio of mortgage loans they manage. The health of this portfolio is tied directly to the health of the organization.

Any loan-loss reserve strategy has its central theme the core principle of value. The true value of a loan portfolio can only be measured by the timeliness and the actual amount of loan payments that are received. This is a constantly changing threshold.

The way risk is managed is through a reserve where a

designated amount of capital is placed to offset delinquencies as well as partial or full non-repayment. The size of the reserve depends on the actual performance of the loan portfolio. More often, this is determined by a systematic approach, known as a risk-rating system, and is generally based on an organization's historical experience with its portfolio.

This loan-loss reserve strategy in essence allows the value of the portfolio to be self-insured. Many details, too complex

to be covered here, should be considered prior to the designation of a loan-loss reserve fund. However, it is easy to see that without a properly managed reserve, an organization with a large lending operation can easily jeopardize its ability to originate new loans—if not its entire organization.

Comes With the Territory

Most community development practitioners assume that risk is a part of their ongoing work. They dare to push the

MANAGING RISK IN THE NEIGHBORWORKS® NETWORK

To Neighborhood Reinvestment and NeighborWorks® organizations, risk management is reduced to an analysis of risk factors that potentially affect three distinct areas:

- ▶ **Corporate Risk** - that directly threatens the financial health and/or programmatic viability of Neighborhood Reinvestment Corporation;
- ▶ **Network Risk** - that directly threatens the financial health and/or programmatic viability of our overall national NeighborWorks® network; and
- ▶ **NeighborWorks® Organization Risk** - that directly threatens the financial health and/or programmatic viability of individual NeighborWorks® organizations.

Risks, in turn, are assessed according to eight indicators:

- ▶ **Competency or Transition of Key Personnel:** Transition of executive director, financial manager or board president may cause problems; mitigation elements might include advance planning, collaborative relationships and supportive funders.
- ▶ **Loss of Resources or Support from Funders:** Risk occurs when an organization loses key funders or revenue-generating activities fail to meet their goals. Mitigation strategies include formal and ongoing cash-flow projection reports, strong communication

links and leadership-development maintenance.

- ▶ **Production Stability:** Substantial “ups” and “downs” in production and/or failure to meet contractual production goals leading to resource deficits directly affects risk. Risk mitigation might include analysis of economic-marketplace dynamics, understanding competitive forces, internal staff training, etc.
- ▶ **Shift in Program Direction:** The potential for greater risk is present when an organization initiates or more heavily concentrates on a new programmatic direction without considering experience and/or training in the new area of focus. Mitigation would include ongoing corporate planning, adequate cash-flow analyses and adherence to corporate mission.
- ▶ **Poor Board and/or Partnership Oversight:** Risk occurs when an organization's board and leadership structure becomes less actively involved and/or fails to understand or maintain its legal and fiduciary responsibilities. Mitigation would involve updated management-information systems and processes, a balanced and renewed leadership-development strategy, and ongoing board-recruitment activities.
- ▶ **Balance Sheet Composition—Asset Imbalance:** There is often a higher organizational risk asso-

ciated with a higher degree of debt, concentration of assets in a limited asset base (such as a single property) or if notes receivable are considered unlikely to be paid. Again, mitigation would include solid MIS and financial-management systems that provide some degree of self-generating risk prediction (ratio formulation, trend analysis, etc.).

- ▶ **Economic, Regulatory and Political Environment:** Risks may increase due to changes in the external environment, such as regional recessions resulting in plant closings, political shifts, regulatory mandates, etc. While increasingly difficult to predict and even more difficult to mitigate, marketplace and political changes often result in high-risk environments. Possible risk-intervention strategies might include economic-trend analyses, long-range organizational planning, and establishing and maintaining collaborative partnership opportunities.
- ▶ **Internal Systems—Financial and Organizational Management:** This risk includes a wide range of financial and legal considerations, including contract compliance, paid payroll taxes, timely unqualified audits, sound loan servicing, key insurance, etc. Risk mitigation would include maintaining updated financial- and information-management systems, development of internal



envelope, to exceed the norm in trying to create neighborhoods and communities that are places of choice for persons of mixed incomes, races and ethnicity.

Real-life risk issues that impact our work focus much more on understanding and preparing to take those risks that we know are unavoidable in distressed communities and underserved rural areas. Neighborhood Reinvestment understands and recognizes this in its grant-making, audit and monitoring functions, as well as in its overall

endorsement of the innovative and creative activities and strategies employed by NeighborWorks® organizations.

Risk comes with the territory in our business. Identifying, analyzing and mitigating that risk—when and where possible—does as well. ■

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quality control models, and ongoing internal auditing.

NeighborWorks® organizations run the gamut of exposure to the above risk indicators, and our experience has been that, for the most part, risk identification is key to adequate mitigation.

Unless there are staff who are given clear and specific tasks to evaluate potential risks, it can often be difficult for an organization to accurately identify risk factors itself, since the reality of “day-to-day” operations often overshadows perceptions of non-immediate risks.

Illustration: Key Personnel

One example can be found with a highly visible, highly productive organization located in a major city in the Northeast. With the complexity of several subsidiary corporations, and an ongoing difficulty in generating timely and informative financial reports and audits, it was hard for the board and executive director to fully understand the need for senior staff oversight of all their financial operations. Combine this with a salary ceiling and a highly competitive marketplace for recruiting and retaining qualified financial personnel, and you had an otherwise-solid and well-respected organization without a clear picture of its overall financial condition.

Here was a risk level characterized by the indicator “Competency or Transition of Key Personnel.” Once identified as a high risk through

external assessment, the mitigation course became clear.

Illustration: New Program Direction

Another typical area of high risk that often goes undetected is the rapid build-up of an organization's real-estate development component. A very successful home-ownership-focused program in a midsize city in the Southeast was the recipient of a large amount of funding for an affordable-housing subdivision. Land was donated and subsidies were in place for what seemed to be a natural programmatic progression for the 15-year-old program. A ready-made formula for success.

However, several risk indicators came into play that ultimately provided serious exposure to the organization. Most prominent was “Shift in Program Direction.” Although the organization felt it had considered the pros and cons of embarking on a real estate development project, it had not fully embraced a planning process that included board and other funders prior to accepting the challenge (and the project funding). Nor had it prepared itself administratively for the various spin-off effects such a large programmatic shift would have on its existing operations.

Although the organization did hire an additional staff member to “manage” the project, many risk areas were subsequently identified beyond

this staff member's primary role. On the accounting side alone, no provisions were made to adapt the existing chart of accounts to allow for proper accounting. Little if any real project tracking systems were put in place to provide for early warning signs as to construction-cost monitoring, draw delays, etc. And, perhaps most importantly, the liability exposure of board members and officers was greatly underestimated.

The project was completed and several lessons on risk management were learned in the process. The organization now has a much deeper appreciation of the importance of identifying and assessing risk as it embarks on new ventures.

Cost of Doing Business

These are but two of many such experiences throughout our network and within the overall community development field that can be cited. The importance of understanding the dynamics involved with risk, and preparing your organization for managing it, is crucial as our projects and real-estate ventures become larger and more financially complex.

The cost of doing business is something we all need to understand. Identifying, assessing and mitigating risk is a basic part of that cost. For nonprofit organizations in the community development and affordable housing business, it is a cost we no longer can afford to ignore. ■