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Rating U.S. CDFI Banking Organizations

Banking institutions providing services to economically distressed markets or populations have performed an important role in most economies and banking systems. In the United States, the U.S. Treasury Department has developed a program for designating certain institutions serving these markets (from credit unions to loan funds, venture capital funds and banks) as “Community Development Financial Institutions” (CDFIs). This report provides a general background of the unique business and financial profile of banks and bank (or thrift) holding companies (BHCs) having CDFI designations, as well as A.M. Best Co.’s performance metrics and rating analytical framework for assessing their financial strength.

Banks and BHCs generally are rated according to A.M. Best’s *Rating Methodology For Banks*, <http://www.ambest.com/banks/reports/ambest-bankingmethodology.pdf>. The rating analytical framework for banking organizations having CDFI designations considers not only their distinctive business and financial profile, but also the community-development aspects that have a significant impact on their operations, funding, access to capital and potentially their long-term viability. This report outlines how A.M. Best applies its bank methodology to CDFIs, and discusses some of the unique characteristics of these organizations and how they are viewed in the rating process.

Special Background, Characteristics Of the CDFI Banking Segment

The U.S. Treasury Department has designated financial organizations working in market niches that are underserved by traditional financial institutions as Community Development Financial Institutions (CDFIs). CDFI certification is a designation conferred by the CDFI Fund and is a requirement for accessing financial assistance from the CDFI Fund through the CDFI Program; Native American CDFI Assistance (NACA) Program; and certain benefits under the Bank Enterprise Awards Program to support an organization’s established community-development financing programs. For a banking institution or BHC (or a thrift or thrift holding company) to receive a CDFI designation, it must have a primary mission of promoting community development, having at least 60% of its financing activity focused in one or more specific target markets. These target markets may be within geographic areas – falling below quantitative economic benchmarks – or within underserved or low-income segments of the population. The bank or BHC also must maintain accountability to its target market – for example, through board representation – and provide community development services such as financial education, assistance in drafting business plans or homebuyer counseling in conjunction with its financing products.

Special Characteristics of CDFI Banks

CDFI-designated banks and thrifts have various types of banking charters but share two common characteristics: a community-development mandate and access to financial and operating supports



from the U.S. Treasury Department’s CDFI Program. Notwithstanding the wide variety of individual bank profiles, as a group, these banks generally exhibit the following:

- They have dual goals of meeting CDFI mandates and complying with banking regulations.
- They receive special advantages afforded to CDFI banks, including supports encouraged by regulations; competitive financial awards from the CDFI Fund; or support from various constituents sympathetic to the concept of community development banking.
- As a group, they exhibit less favorable traditional banking metrics than mainstream banks in a number of areas, including:
 - lower profitability, even with implicit and explicit government and other non-market based supports to earnings;
 - higher degrees of business and operational risks from servicing customers not served by many mainstream banks; and
 - more limited access to investor capital.
- However, taking their dual status in total, CDFI banks’ overall creditworthiness and ability to honor their obligations to various counterparties warrant higher financial strength profiles than cases based purely on traditional banking metrics.

In analyzing a particular CDFI bank or BHC, A.M. Best first determines how the segment, with its special characteristics, is responding to the current economic and regulatory environment. Those aspects are considered in light of traditional banking groups having similar locations or asset sizes. Against that backdrop, in-depth reviews are performed on the three primary areas – business profile, operating performance and balance sheet strength – of both the primary banking operation and the rest of the affiliated group.

Business Profile

As with traditional banks, business profile for CDFI banks is an important qualitative component of the rating analysis. Highly rated companies must demonstrate a strong business profile that reflects the

degree of risk inherent in the bank’s book of business, the quality and stability of its management, and the strength of its franchise.

Dual focus of community development and financial viability due to regulated banking status. The dual focus imposed by the CDFI designation and banking charter at times presents opposing objectives to CDFI banks, which in turn present special challenges for analysts in understanding their operations. On one hand, CDFI banks pursue community development mandates and engage nonprofit organizations;

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on the other hand, as regulated entities, these banks are profit-oriented institutions subject to regulatory requirements with respect to acceptable limits on risk-taking and maintenance of certain capital levels.

CDFI banks face special internal issues as a result of this dual focus. There may be inherent trade-offs when setting financial, operational and strategic business directives while balancing the two sets of goals. CDFI banks also may contend with two sets of competitors: the nonprofit segment and traditional banks. As a result, CDFI banks range across varying degrees of commitment to community development versus traditional banking. In all cases, however, a special profile of the senior management team and board is necessary for a successful operation. As will be discussed further, A.M. Best in its rating analysis conducts probing interviews with management to assess the leadership profile in light of the business model.

Wide range of constituencies reflecting support of CDFI banks from government, nongovernment organizations and civic-minded individuals. A prominent feature of CDFI banks is the direct and indirect support from nonmarket sources such as governments, nongovernmental organizations, communities and individuals allowing CDFI banks to provide financial services to their communities. In addition, CDFI banks have the opportunity to compete for financial assistance from the CDFI Fund. The U.S. Treasury established the CDFI Fund in 1994 to promote and encourage private-sector institutions to provide credit, capital and financial services to underserved populations and communities in the United States.

The ability of a CDFI bank to engage a diverse group of constituents, while achieving its mission of profitably providing banking services to underserved populations, is critical to the bank's success.

Challenging market conditions of economically underserved areas. Except for certain special opportunities, general economic conditions of underserved markets are less robust than in traditional markets targeted by mainstream banks. Local businesses are more likely to be unique startups rather than chain businesses following a standardized pattern or chain franchise

model. Furthermore, larger and more profit-based businesses may have less of a presence in these markets, further concentrating the economic base in local, small businesses.

On the other hand, A.M. Best recognizes that special opportunities may exist with compelling rewards for businesses that are committed to these communities. The avoidance by larger, recognized businesses may reduce competition. The ties and loyalty of customers in these markets to local businesses tend to be strong, allowing for unconventional business practices and resolution of business issues. While a CDFI bank faces a wide range of circumstances, those that have established successful operations serving the basic banking needs of communities may be quite viable, despite challenging local economic conditions.

Given operational diversity among CDFI banks, rating analysts first consider a particular bank's business model and targeted lending market to understand its lending culture. This includes borrower risk profiles as well as local availability of mainstream banking in the market area.

The relative lack of operating scale and segment maturation in CDFI banking. The CDFI bank segment remains relatively new and small in number and consists largely of small, community banks, with only a few midsize community banking organizations. While some community development banks existed before, in many cases, new banks were formed with community development banking as an initial business model after the CDFI Fund was established in 1994. The preponderance of relatively new CDFI banks awarded the designation, without having a long history of successful operating experience, has not yet allowed for the full development of best practices in managing these banks. As a result, CDFI banks as a group have not had the same level of access to financial and capital markets as mainstream banks.

A.M. Best's criteria for assessing the relative strength of a CDFI bank's business profile consider how the factors above determine the relative strength of its franchise in terms of its ability to consistently generate not only good financial performance,

but also community-development results pursuant to its business mandate.

Risk management and corporate governance. An in-depth review of a banking group’s risk management to better understand its operations and financial condition is an important cornerstone of an interactive credit rating. A.M. Best acquires this qualitative information through interviews with the rated entity, as well as a review of internal documents. The interaction provides the background necessary for a meaningful analysis of the financial reports and other quantitative indicators. While A.M. Best conducts a comprehensive analysis of all aspects of a CDFI bank’s risk management, as is conducted for other banks, the following areas are highlighted as key elements for CDFI banks:

- Credit risk management policies and procedures
- Profile of management team and board of directors
- Transparency and effectiveness of communication to constituents

Credit risk management as the key component. As indicated above, for most CDFI banks, credit risk is probably the most prominent rating factor. A critical part of understanding a bank’s credit risk exposure is through its credit risk management. A.M. Best engages management in a discussion regarding the bank’s broad risk profile; risk-selection criteria; credit underwriting and approval processes; monitoring procedures for loans both individually and portfolio-wide; stress-testing procedures; and a problem loan resolution system. Management’s responses should reflect an appreciation for the particular circumstances of the bank’s markets and demonstrate a proactive risk management system that begins with risk selection and pricing, and concludes with close, ongoing loan monitoring.

On the other hand, these organizations typically are community banks that have assumed less risk in areas such as market or liquidity risk, making risk management more streamlined in other respects.

Profile of management team and board of directors as bank managers having dual objectives. Managing CDFI banks is

especially challenging given their business models and complex sets of regulators and other stakeholders. An unusual skill set is required of leadership, who often are required to maintain relationships on behalf of the organization with local government and community groups; a greater number of different regulators; local and potentially distant socially conscious investors; and business leaders.

In addition, the business model requires creativity to develop unique products and services – in many cases products that never have been developed at other organizations. Management must be able to organize and respond to a greater variety of products, customers and stakeholders.

A.M. Best requests information regarding the board of directors of a CDFI bank to understand the board representation and the bank’s capacity to engage community leaders. Board representation additionally is a critical way CDFI banks can engage diverse constituents in their mission.

Transparency and effectiveness of communications to all constituent groups. CDFI banks face high communication burdens, partly because of their small size and wide variety of constituents. The unusual nature of some CDFI bank operations and performance may be difficult to quantify, explain or even account for using appropriate accounting methods in financial reporting. Bank Enterprise Awards (BEAs), which are a significant component of noninterest income, are received in a lump sum on an annual basis from the CDFI fund, typically toward the end of a fiscal year to reward banks after community development work is completed and related expenditures are made. Similarly, some expenditures and revenues contain both market and nonmarket components such as assistance with drafting business plans or partially subsidized deposit rates. Yet, while the complexity in reporting or interpreting results can be difficult for these small banks, CDFI banks need to communicate transparently to various groups of stakeholders with divergent perspectives and goals.

While not specifically opining on accounting methods, A.M. Best reviews especially the CDFI bank’s financial reports as part

of its transparency analysis. While recognizing the limited resources available to a typically small CDFI bank, A.M. Best nonetheless seeks a consistent application of accounting policies conforming to industry standards to facilitate peer comparison. If the financial reports of a particular CDFI bank lack transparency, other target audiences may be unable to correctly understand the bank's performance and business model, and the longer term prospects of a bank's financial management might be undermined for lack of clarity.

Balance Sheet Strength

As a group, the CDFI banks' balance sheet profile also reflects their having a community development mandate while competing as mainstream banks. The following areas distinguish the balance sheet profile of CDFI banks from that of mainstream community banks:

- Loan asset mix has higher levels of local small business financing, including custom underwriting, offset by lower risk in other areas, such as market risk.
- Liability structure exhibits different deposit characteristics.
- Loan asset quality measures indicate lower asset quality.
- Capital levels are lower.
- Balance sheet liquidity is higher on average than at mainstream banks.

Asset mix concentrated around small local business loans, with the high credit risk offset by prudent balance sheet management elsewhere. While specific business models vary, CDFI banks' primary mission is to provide financing and banking services to businesses and populations located in underserved markets. Given the focus on local development and the preponderance of loan assets not conforming to standardized structures that facilitate securitization or asset sales, these banks generally lend and hold the loan assets on their balance sheets. Consequently, the asset mix of CDFI banks tends to be concentrated in small local business loans, which carry high yields but at the same time high credit risk. An important aspect

of A.M. Best's analysis of CDFI banks is determining how well the management of a CDFI bank recognizes this primary risk on its balance sheet and properly manages it by implementing appropriate organizational structures and risk management systems. In some cases, this can be more difficult for CDFI banks because their business models may include a different risk profile or a number of individual risks that are more difficult to aggregate for risk management purposes.

CDFI banks' other assets – most notably investments – are intended more for liquidity than for enhancing yield. Generally, CDFI banks tend to balance the higher credit risk in their loan portfolio and the resources required to manage it properly with a simple and low-credit-risk investment portfolio. Furthermore, investments are not as direct a vehicle as loans are for these banks to carry out their community-development focus. Other than traditional, fixed-income investments such as agency debt instruments, CDFI banks show higher levels of municipal debt as compared with mainstream banks. Such debt usually is issued by these banks' respective local municipalities or those with which they have relationships. A.M. Best reviews the bank's investment strategy to better understand the risk involved.

Liability mix consistent with small community banks' profile of customer deposits and short-term borrowings, but with distinct deposit characteristics. CDFI banks' liability mix is similar to that of mainstream community banks; however, CDFI banks' focus on community development engages some depositor ties that render deposits less volatile. This is evident in the higher average levels of large certificates of deposit on CDFI banks' balance sheets. CDFI banks enjoy deposits placed by other banks to meet requirements of the Community Reinvestment Act; by corporations seeking to publicly or visibly support their communities; or by local governments as encouraged by various government programs. As small business lenders, some CDFI banks also are able to maintain higher levels of stable small business demand deposits.

As circumstances may vary, A.M. Best assesses how the unique characteristics

of a particular bank's sources of funding impact their viability, diversity and stability. CDFI banks usually have a series of programs to solicit deposits from shareholders, governments, local businesses, nonprofit organizations, socially conscious individuals and the like. A key component of a rating analysis concerns the long-term effectiveness of deposit-generating outreach programs that potentially lower overall funding costs and stabilize liquidity.

Asset quality measures generally lower than mainstream peers. The credit costs of CDFI banks as a group tend to be higher than those of their peers in mainstream community banking. CDFI banks are more likely to address and accommodate the unique profiles of borrowers and may avoid penalizing a business or other borrower that has not yet established a credit profile. Customized underwriting criteria and processes are a key part of providing loans to CDFI banks' target markets. Furthermore, these loans require close monitoring and aggressive, ongoing risk management. It should be noted that even if actual loan losses reported by a CDFI bank are within normal ranges, there may be inherently greater credit risks due to higher levels of custom underwriting.

In recognition of these risks, loan guarantees may be available from local governments or nonprofit organizations to help offset the credit risk assumed by community development banks. Some individual CDFI banks are able to take full advantage of these special loan guarantee programs, enabling them to consider more challenging credit extensions and/or unconventional types of borrowers. As another mitigating factor to the credit risk facing CDFI banks, the close community ties these banks enjoy can aid in restructuring or negotiation of repayments for nonperforming borrowers in a number of nontraditional ways. CDFI banks may benefit from more collaborative relationships with customers and borrowers that allow for different and sometimes more beneficial resolutions of troubled loans.

Notwithstanding these mitigating factors, CDFI banks as a group show higher levels of nonperforming loans and credit losses when compared with mainstream banks. This

broad, categorical profile does not necessarily apply to all CDFI banks. A.M. Best assesses each CDFI bank individually, based on its unique profile, ability to manage risk and ability to leverage the special benefits of the CDFI designation. Rating analysts also consider any concentrations of risk by borrower or geography in light of the credit risk management systems and procedures at a CDFI bank (as discussed further below).

Finally, A.M. Best considers the adequacy of a CDFI bank's loan loss reserves (allowance for loan and lease losses account, "ALLL") based on all of the asset-quality factors. CDFI banks' ALLL levels generally are in the lower range of mainstream peers, since CDFI banks manage their ALLL account within the boundary of industry levels but assume higher credit risk than the average, mainstream community bank.

Lower capital levels relative to risk exposures. As a group, CDFI banks are less adequately capitalized than their mainstream community bank counterparts. A number of factors may impede CDFI bank holding companies and their banks from accumulating capital:

- Lower earnings, leading to lower capital-regenerating power.
- Generally weaker access to an established investor base due to the special consideration required of investors in CDFI banks.
- A lower dividend-payout history and limited ongoing dividend-paying capacity, which are not as suitable to for-profit investors.
- Higher capital requirements due to higher growth and business-risk profiles, including higher loan-portfolio risks for CDFI banks as a group.

A key consideration by A.M. Best is an assessment of the investor base of the bank, or more typically, its parent holding company. Where applicable, holding companies are the investor-relations arm of the organization through which capital is raised. The quality of the investor base is assessed in terms of its stability, the depth of the pool of investors, the extent of any personal relationships both between these

investors and the bank and among themselves, and finally, the ability and willingness of the investors to provide additional capital if needed. The last component is critical, and analysts are careful to understand the likelihood of a CDFI bank's investor base providing future capital support if needed. The visibility of the organization among potential shareholders, beyond the current base, is assessed for the longer term prospects of a CDFI bank's financial flexibility.

Balance sheet liquidity

Perhaps partially offsetting higher credit and operational risks – and lower capital buffers – CDFI banks tend to manage their balance sheets more conservatively in other respects. CDFI banks' liquidity levels tend to be more than sufficient to support the bank's operations because of a general reliance on low-cost deposits and other straightforward forms of funding. These banks' investment portfolios also tend to be much more conservatively invested, as mentioned above.

Operating Performance

The operating performance of a CDFI bank indicates the extent to which it can sustain its community-development business model while generating the measure of profitability and capital growth expected of a federally insured institution. A.M. Best assesses a CDFI bank's operating performance relative to other CDFI peers, as well as mainstream community banks, with special consideration of each CDFI bank's unique individual and absolute operating performance.

While many of the traditional measures of CDFI banks' operating performance as a group are lower than those of mainstream banks, some individual CDFI banks are well managed and positioned within their markets. Accordingly, there are CDFI banks whose performance is comparable to their mainstream banking peers. Furthermore, CDFI banks' performance measures include the effectiveness of their community-development activity, which directly affects the ongoing supports these banks receive. A wide variety of nonmarket-based opportunities to bolster income or reduce business cost is available to and sought out by CDFI banks and their holding companies.

CDFI banks' operating profile generally shares the following characteristics as compared with mainstream banks:

- Higher levels of low-cost deposit funding.
- Earnings mix containing special noninterest income sources (e.g., grants, etc.).
- Higher noninterest expenses.
- Inherently higher underlying credit costs.

Strong access to lower cost deposits. Government programs, such as the Community Reinvestment Act, promote the economic development of underserved areas and encourage deposits at CDFI banks. Additionally, some foundations and socially conscious investors support community development through deposits in the CDFI banking segment. While these supports are available, the nature and effectiveness of a bank's deposit-gathering strategies can vary greatly among institutions. Thus, an individual CDFI bank may or may not exhibit lower cost deposits, or an overall lower cost of funds, even if there is an advantage associated with the CDFI status. While A.M. Best acknowledges the potential economic advantage of CDFI banks' greater access to low-cost deposit funding, consideration is given only to a specific bank's actual performance in realizing this advantage and converting it to an overall lower cost of funds.

Earnings mix contains special noninterest income sources. CDFI banks' noninterest income is enhanced by CDFI Fund programs such as a Bank Enterprise Award – an outright grant issued annually by the Fund for increases in community-development activity demonstrated by each bank – and New Markets Tax Credits, which are allocated to organizations that invest in Community Development Entities (CDEs) for community development work. Nonmarket sources of income help to offset the high costs of providing development activities and doing business in underserved economic areas. While reliance on government awards to supplement operating income typically is not viewed favorably by analysts, the degree of reliance among banks varies, and historically the CDFI Fund is a well-funded government program that has provided consistent earnings support to CDFI banks.

Higher operating and administrative burden associated with the community-development mandate. The challenges of providing banking services affect CDFI banks most directly through additional burdens on their operating expenses. CDFI banks face greater operating and administrative demands than mainstream banks, primarily because of the mandate to provide development services.

The CDFI community-development mandate requires time and resources. Offering financial education programs, as well as financial and other nonbanking counseling services such as assistance with drafting business plans, are the primary factors raising overhead for CDFI banks. These factors are either absent from traditional banks' operating platforms or have a significantly lower impact. Such activities are required of a CDFI to qualify for the designation.

The nonstandard, custom-lending business model also requires a more elaborate and expensive infrastructure for the delivery of banking services. A higher level of customer service and staffing also may be necessary to accommodate generally less sophisticated customers. Therefore, operations of CDFI banks serving these markets tend to be more labor intensive.

Finally, CDFI banks face a heavier burden of regulatory compliance by virtue of being both small community banks and CDFIs, and also from taking on operational risks that mainstream banks avoid. These compliance burdens contribute further to a CDFI bank's high operating costs. Some products CDFI banks offer also may need to be designed specially in collaboration with various local government or nongovernmental organizations' programs.

As a result, CDFI banks tend to have more employees per asset and higher noninterest expenses as a percentage of average assets. It follows that these banks also have a less favorable efficiency ratio than their mainstream peers. However, some CDFI banks are able to recover some of these costs through high noninterest income.

Higher credit cost and required risk premiums embedded in the higher loan yields. Based on the above-mentioned

characteristics of their markets, CDFI banks assume higher credit risk than their mainstream community bank counterparts, at least in terms of the higher default risk of their borrower base, even if the recovery prospects may or may not be as problematic. CDFI banks' loan yields historically have been incrementally higher than those of mainstream peers, as borrowers in CDFI banks' markets typically are charged higher rates and fees already because of their lack of access to financing. However, these yields might not adequately reflect appropriate risk premiums to compensate for higher credit costs. It also should be noted that CDFI loan relationships typically generate fee income from other banking services and deposit balances. Analysts would consider these important derived benefits when assessing the total loan yields of CDFI banks relative to the credit risk assumed.

A.M. Best additionally reviews the levels of overall asset quality in conjunction with the required loan-loss provisioning to determine whether a CDFI bank is adequately pricing its loans overall. The required loan-loss provisioning in turn is determined by an assessment of the bank's asset quality and credit risk management systems. Should a CDFI bank experience high credit loss trends as a percentage of gross loans, combined with other credit-cost measures, higher loan yields still may be deemed inadequate relative to the risk assumed, and in turn, the bank's profitability would be considered both risky and unsustainable, unless costs can be recovered through other reliable sources, such as fees.

A.M. Best's assessment of CDFI banks' operating performance differs from mainstream banks not just because of the different composition of their earnings, but importantly, because of the dynamics and impacts of these expenses and sources on these banks' underlying operations when compared with the relatively efficient mainstream banking market in the United States.

Conclusion

As mentioned above, A.M. Best considers the special characteristics and related issues of CDFI banks under the same standards and

approach as it would consider the unique characteristics of every bank being rated, in accordance with the A. M. Best's Rating Methodology for Banks. This methodology sets forth those specific considerations as they apply to the CDFI segment in an effort to inform the industry and other users of bank ratings.

This CDFI methodology describes the current structure and financial characteristics

of the CDFI segment and addresses the attendant issues requiring special consideration in A.M. Best's rating analysis. The CDFI designation is fairly new, and the segment continues to develop. A.M. Best's approach to analysis will continue to evolve with this banking segment to reflect any changes in the CDFI program, as well as further developments in the banks receiving designation under this program.



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