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Opportunities and Constraints for East Oakland Development Bank: Lessons from South Shore Bank

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Opportunities and Constraints for East Oakland Development Bank: Lessons from South Shore Bank

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THE UNIVERSITY-OAKLAND METROPOLITAN FORUM SERIES

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University of California at Berkeley
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Introduction

This paper combines information and analysis on South Shore Bank, the national model for a development bank, with a feasibility study of the prospects for a development bank in East Oakland. It provides data for the National Community Reinvestment Bancorp. Organizing Group, the organizers of the Oakland bank. The intent of the paper is to offer the Oakland organizers perspectives based on the South Shore Bank experience as they consider alternative methods of generating capital for housing and economic development in Oakland's neighborhoods.

A development bank is a community bank which has a commitment to invest in the development of the community where it is located. South Shore Bank, the only active development bank in the nation, has created a neighborhood revitalization model which stresses the institutional strength and stable source of capital which a community bank can provide in a low-income community. As a profitable entity, South Shore Bank has shown that it is possible for a bank to fulfill a community development mission and allow for a competitive return to its investors.

This paper is divided into two major sections. The first focuses on information about the history and practices of South Shore Bank, while the second looks at the potential for the replication of the development bank model in East Oakland based on the South Shore experience.

The section on South Shore Bank history and practices begins with a brief description of South Shore, a history of the purchase of South Shore Bank, and an examination of the goals of the bank. The section also includes information on the community development strategy used by South Shore Bank, and the profitability and financial management of the bank.

The second section discusses the feasibility of establishing a development bank with a primary focus on the East Oakland neighborhood of Elmhurst and a secondary focus on the adjoining neighborhood of Central East Oakland. The section looks at how subsidizing mortgage interest rates would affect the bank's balance sheet and the opportunities this would create for Elmhurst residents to purchase homes in the neighborhood. The section also examines several feasibility issues which the organizers of the Oakland bank will need to consider.

The paper concludes with a short recap of conditions which should be present to establish a development bank in a community. This highlights the difficulty of starting a development bank in East Oakland, and concludes that the overall likelihood of a successful development bank in Oakland is low.

PART 1. HISTORY AND OPERATION OF SOUTH SHORE BANK.

Background on South Shore

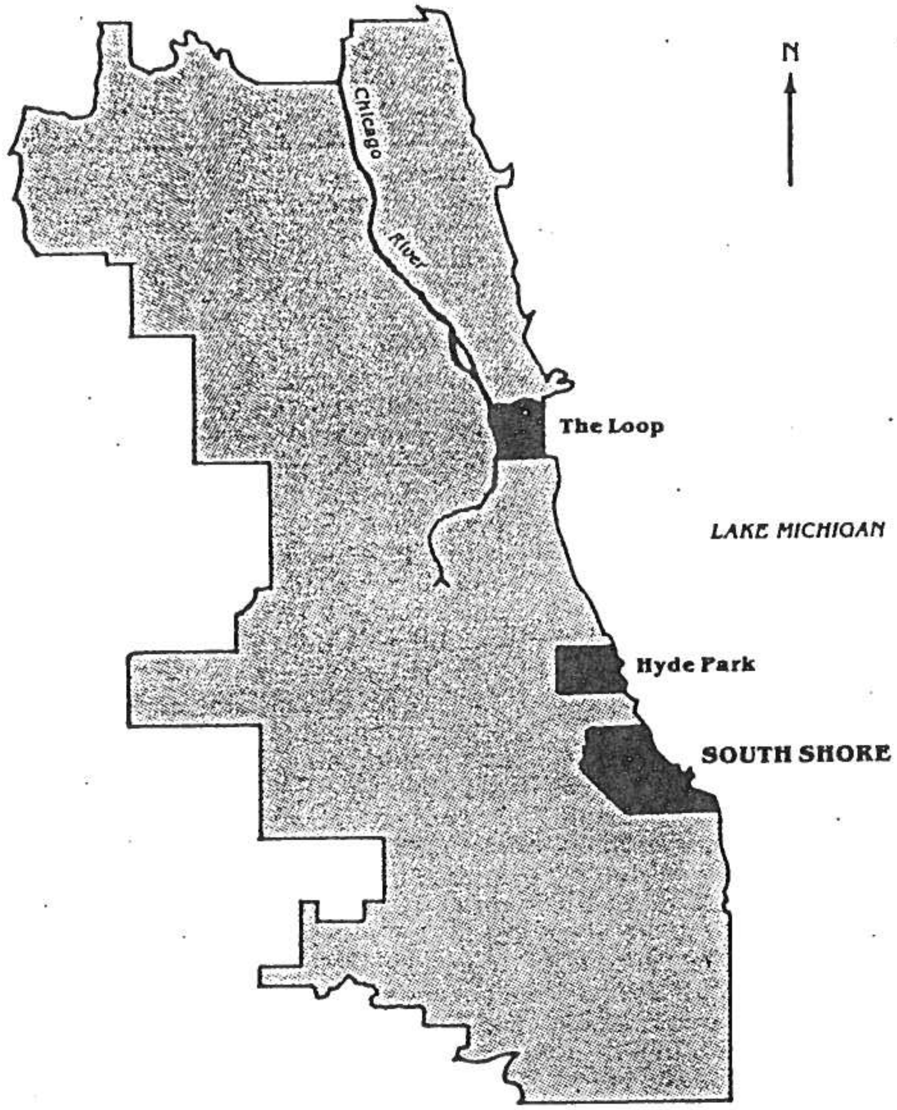
South Shore is a Chicago neighborhood located 8 miles south of downtown, along the Lake Michigan shore (see map). The area benefits from a diverse housing stock, good transportation links to downtown, proximity to superb recreation facilities, and its lakefront location. However, it suffers from a large number of dilapidated apartment buildings, uncompetitive and unattractive shopping strips, and high levels of unemployment and poverty among neighborhood residents.

South Shore, like many other Chicago neighborhoods, experienced tremendous racial and economic changes in the 1960's and 1970's. In 1980, South Shore had a population of 77,743, 95.1 % of whom were black. In 1960, (see Graph 1) South Shore had no black residents. By 1966, the percentage was 33 %. It increased to 68 % by 1970, and 88 % by 1972. Thus between 1960 and 1980, the population of South Shore turned over almost completely.

South Shore experienced economic decline during the 1960's and 70's. In 1969, the median family income in South Shore was $ 10,460, 9 % higher than the national median. By 1978, South Shore's median income was estimated to be $ 13,000, only 74 % of the national median. In 1980, 20 % of the population received public assistance. Property values fell in constant dollars. The median home value in South Shore rose from about $ 23,000 in 1960 to $ 25,000 in 1970, while there was a 35 % increase in consumer prices during that decade.

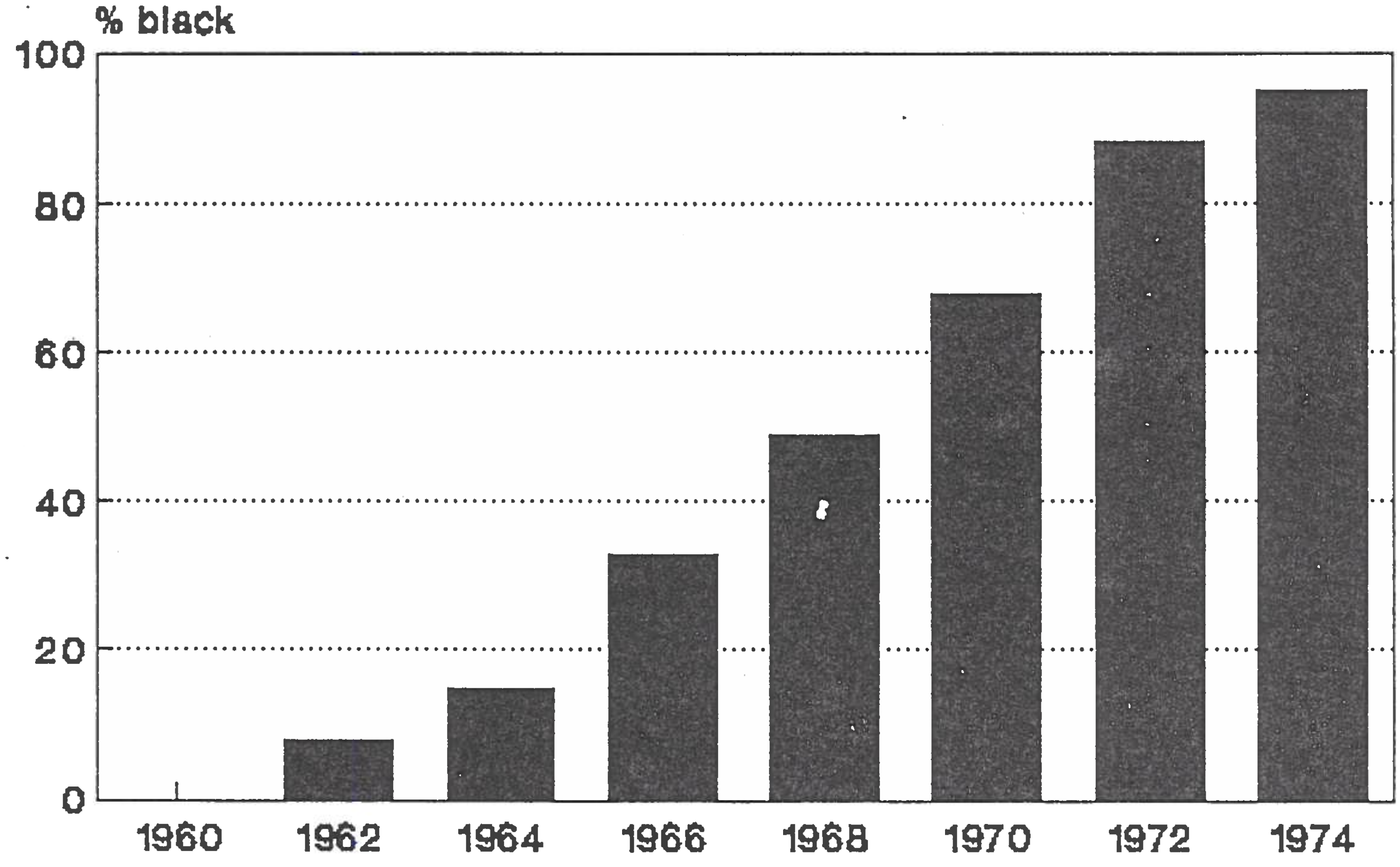
South Shore in relation to downtown Chicago (the Loop).

City of Chicago Community Areas



GRAPH # 1

Bi-Yearly Estimates of Race in South Shore, 1960-1974.



Source:

The outflow of capital from South Shore became evident in the poor physical quality of local shopping strips and housing. The neighborhood began to experience the abandonment of its housing stock, particularly in single-family properties financed by Federal Housing Administration insured mortgages which went into default. Tax delinquent housing rose from being non-existant in 1968 to 31 % of all large rental properties by 1976. (see table 2).[1] Merchants began to leave the shopping strips. Financial institutions became reluctant to lend in the neighborhood. South Shore developed a negative image in Chicago, and lost the confidence of residents, investors, and business people.

The Purchase of South Shore Bank.

The South Shore National Bank had been located in the center of South Shore since 1939. As racial change accelerated, the bank's ownership saw its financial condition and prospects for future profitability eroding. The bank's residential lending in South Shore lessened considerably, from 65 mortgage loans made between 1966 and 1969, to 16 loans originated from 1970 to 1973.[2] By 1972, the bank was ready to relocate to downtown Chicago pending approval by the Comptroller of the Currency. However, in an unprecedented action, the approval was denied after a challenge by South Shore community groups who argued that the bank's departure from the neighborhood would seriously undermine the vitality of the South Shore economy.

After the Comptroller's ruling, the bank's owners were

Table 2. Tax Delinquency Indicators for Large Rental Properties in South Shore, 1964 - 1979

Year	Total Buildings Paying Tax	Forfeit	Total Sold/ Redeemed	Total Tax Stress	Problem Buildings as a Percentage
1964	291	0	0	0	0
1965	288	0	3	3	1
1966	289	0	2	2	0.6
1967	289	0	4	2	0.6
1968	291	0	0	0	0
1969	289	0	2	2	0.6
1970	284	3	4	7	2
1971	255	25	11	36	12
1972	241	39	11	50	17
1973	245	40	6	46	16
1974	221	66	4	70	24
1975	210	62	19	81	28
1976	201	77	13	90	31
1977	202	68	21	89	31
1978	228	51	12	63	22
1979	239	59	NA	52	18

NA: At the time this chart was produced, the data on Total Buildings Sold/Redeemed was unavailable for 1979.

Source: Property Tax Judgment Information, Cook County Court, Compiled Robert Giloth. From the Evaluation of the Illinois Neighborhood Neighborhood Development Corporation. Woodstock Institute, 1982.

approached by a group led by Ron Grzywinski, the former President of the Hyde Park Bank of Chicago. Grzywinski was looking to purchase a bank in a minority community to implement a community development model he had developed through research at the Adlai Stevenson Institute, in which a bank holding company would provide the vehicle for revitalizing an inner-city community. In August 1973, Grzywinski, through his holding company, the Illinois Neighborhood Development Corporation (now Shorebank Corporation), bought the South Shore National Bank for $ 3.2 million. The purchase was financed through a $ 2.4 million loan from the American National Bank, the interest on which floats with the prime. The organizers were also able to raise $ 800,000 in equity from church groups, foundations, corporations, and individual investors.

The South Shore Community Development Model.

The new owners of South Shore Bank bought the bank under the premise that the best model for self-sustaining neighborhood development was a bank holding company mandated to finance community development and earn a profit. The bank would focus its lending in a single community, make a special effort to make credit available to neighborhood residents and businesses, and work to attract other sources of credit and development capital to the area. The holding company would tie the bank to several subsidiaries that could undertake development activities which the bank could not legally do, such as buying real estate and making equity investments in businesses.

By 1978, four subsidiaries of the Illinois Neighborhood Development Corporation were in operation (see table 3). The first was South Shore Bank itself. The others were the Citylands Corporation, a for-profit real estate development and management company, the Neighborhood Fund, an SBA licensed Minority Enterprise Small Business Investment Corporation which finances small businesses through equity investments and long-term subordinated debt, and the Neighborhood Institute, a neighborhood economic and social development organization.

Grzywinski was explicit about his plans for the bank. The Offering Circular for the Illinois Neighborhood Development Corporation read:

"While the policy of the corporation is to make loans and investments only in situations which it believes will offer a reasonable expectation of return, it will not attempt to maximize such return at the expense of its primary goal of developing the neighborhood for the benefit of its residents."[3]

The new owners established the following goals in attempting to foster neighborhood development and generate a competitive rate of return on invested capital:

1. To serve as a vehicle for the development of South Shore through the provision of credit for single and multi-family housing purchases and rehabilitation, small businesses, community-based non-profits, and consumers.

2. To meet the credit needs of residents who have been arbitrarily denied credit because of racial or geographic discrimination.

3. To be a catalyst for community development activities by residents, other private actors, and the public sector.

4. To attract external public and private resources to South Shore.

5. To earn a competitive rate of return on equity.

TABLE # 3

SHOREBANK CORPORATION

A REGULATED BANK HOLDING COMPANY

SOUTH SHORE BANK

- 99% OWNED SUBSIDIARY
- PRIMARY SOURCE OF DEVELOPMENT CREDIT
- A SMALL BUSINESS ADMINISTRATION (SBA) "PREFERRED LENDER"

CITY LANDS CORPORATION

- 100% OWNED SUBSIDIARY ORGANIZED FOR PROFIT
- INITIATES AND MANAGES REAL ESTATE REHABILITATION PROJECTS

THE NEIGHBORHOOD INSTITUTE

- 501(c) (3) TAX-EXEMPT AFFILIATE
- FUNDED ENTIRELY THROUGH FOUNDATION GRANTS AND GOVERNMENT CONTRACTS
- INITIATES AND MANAGES SOCIAL AND ECONOMIC DEVELOPMENT PROJECTS
- INDEPENDENT COMMUNITY BOARD OF DIRECTORS

TNI DEVELOPMENT CORPORATION

- FOR PROFIT SUBSIDIARY
- DEVELOPS RENTAL AND COOPERATIVE HOUSING FOR LOW-INCOME RESIDENTS

THE NEIGHBORHOOD FUND

- 100% OWNED SUBSIDIARY ORGANIZED FOR PROFIT
- AN SBA LICENSED MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT CORPORATION (MESBIC)
- MAKES EQUITY CAPITAL AND SUBORDINATED LOAN INVESTMENTS

6. To be a competitive and prudently operated commercial bank.

7. To demonstrate to the banking industry and society at large that a commercial bank can be profitable in a black neighborhood even while financing substantial rehabilitation efforts which do not offer the profit maximization opportunities available from other investments.

8. To demonstrate that in the long run, an economically revitalized South Shore will serve the financial interests of South Shore Bank.[4]

The South Shore Bank Community Development Strategy.

After the new owners took over South Shore Bank, the bank concentrated on making single-family mortgage loans, with the intent of attracting mortgage funds from other lenders to the neighborhood. By 1979, having successfully accomplished this, the bank began to de-emphasize single family lending and concentrated on the rehabilitation of multi-family buildings. The bank has pumped $ 35 million into multi-family buildings in South Shore. This has meant the rehabilitation of more than 6000 units, 18 % of the neighborhood's total. Through the history of the bank, high priority has been given to lending to merchants located in South Shore's shopping districts. Unfortunately, thus far, this activity has been unable to foster significant revitalization along the neighborhood's shopping strips.

South Shore Bank initially concentrated on single-family lending because management felt that the single-family market could be stabilized more quickly, less expensively, and with less risk than multi-family stock, which was in worse condition. The bank actively looked for potential homeowners, and made important assumptions about the neighborhood and loan candidates which other lenders would not make. For example, it was willing to assume that housing in South Shore would appreciate, and considered the income of a woman on an equal basis with the income of a man. These loans turned out to represent minimal default risk. Of the 371 single-family mortgage loans made by South Shore Bank between 1974 and 1980, no foreclosures occurred. The bank also succeeded in its goal of attracting other capital sources to South Shore. In 1975, South Shore Bank accounted for 57 % of the conventional single-family mortgages originated in South Shore. By 1980, that percentage had dropped to 12 %.[5]

In 1975, South Shore Bank decided to make a major commitment to stimulate the rehabilitation of multi-family housing in South Shore. Bank management conceived a plan to concentrate multi-family lending in small areas, which could have the greatest positive impact on the neighborhood. Since half of South Shore's population live in buildings containing between 5 and 49 units, the rehab of large, multi-family buildings meant improved housing for a large number of people. This in turn would support investment on the blocks surrounding the buildings, and help attract additional capital to the area.

South Shore Bank attributes some of its success in the multi-family market to the uncovering of an "untapped" market for credit for rehab. These were owners of 2 to 6 unit buildings who were often couples in their mid-to-late 30's who lived in the buildings, and who were almost exclusively black. The median annual income of these mortgagors was $ 28,000. These loans were perceived to be less risky than loans to owners of large buildings because the mortgagors were owner-occupants, and the loan amounts were comparatively small.

South Shore Bank's multi-family program had other important attributes. First, the bank required recipients of rehab loans to emphasize improvements in structural condition, security, and energy efficiency of buildings. Also, the bank was likely to work with its affiliates on multi-family projects. For example, South Shore Bank would provide the financing for a project which the Citylands Corporation would develop and manage.

The bank has been able to build a solid portfolio of loans for South Shore buildings. Since 1981, South Shore Bank has sold \$ 3.5 million in mortgages to Equitable Life and the Traveler's Insurance Companies. This was the first purchase by corporate investors of a pool of conventional mortgages on older, multi-family buildings in a minority neighborhood. Equitable Life also committed to an additional \$ 1.5 million purchase in 1987.[6]

South Shore Bank has had less success with its business lending program. The bank has made over 500 loans to South Shore businesses totaling more than \$ 13 million. It has extended credit to many businesses which would have been unable to secure conventional financing, has helped create ownership and employment opportunities for South Shore residents, and offered management assistance which has helped local businesses become competitive.

However, South Shore's shopping strips continue to be economically and physically depressed. The bank has been unable to produce sufficient momentum to revitalize the shopping strips through responding to the credit needs of local small businesses. The bank has recently changed its strategy, and through the Citylands Corporation, is developing a new 100,000 square foot shopping center in South Shore. This will help the neighborhood compete with suburban malls, and other Chicago neighborhoods, which are moving away from strip shopping to inner-city shopping centers.

Profitability and Financial Management

South Shore Bank has been able to generate a profit, although a small one, each year since 1974. After the bank was purchased, assets increased by 133 % between 1974 and 1980 (total assets were $ 97 million in 1980, see Table 4). This was a major turnaround. The most important source of new funds were "development deposits" solicited from people and institutions from outside South Shore. These are standard banking products, such as Money Markets and Certificates of Deposits, which South Shore Bank markets to people seeking to support community development and receive a competitive rate of return. Through 1986, the bank raised $ 48 million in development deposits, representing 37 % of South Shore Bank's total deposits. At that time. total assets were $ 131 million.

The bank was moderately profitable each year through 1980, when it had a net income of $ 432,000. The bank's profit margin shrank in the recession years of 1981 and 1982. In 1982, South

TABLE 4: South Shore Bank, Ten Year Financial Summary. 1977-1986.

	1986	1985	1984	1983	1982	1981	1980	1979	1978	1977
000's omitted										
STATEMENT OF CONDITION										
Total Assets	$131,173	$120,072	$106,317	$103,660	$86,408	$80,859	$81,957	$76,257	$76,972	$65,607
Net Loans Outstanding	76,313	77,553	68,169	60,506	59,320	54,596	50,388	46,958	36,815	29,711
Deposits	119,160	110,450	95,937	95,114	77,031	72,982	75,435	64,806	57,360	59,549
Loan LossReserve	956	959	887	674	602	180	217	129	102	159
Stockholders' Equity	10,178	7,650	6,832	6,468	6,174	4,877	4,347	4,301	4,070	4,003
OPERATING STATEMENT										
Net Operating Income	1,679	1,925	1,053	841	131	117	351	275	120	222
Net Income (Loss)	1,389	1,263	663	847	48	36	432	301	208	424
FINANCIAL RATIOS %										
Primary Capital Ratio at Year End	8.43	7.11	7.26	6.89	7.84	6.25	5.57	5.81	5.42	6.34
Net Return on Average Equity	16.94	18.04	9.97	13.40	0.87	0.78	9.99	7.19	5.15	11.91
Net Return on Average Assets	1.10	1.13	0.63	0.89	0.06	0.04	0.55	0.39	0.29	0.71

Source: South Shore Bank, Annual Report, 1986.

Shore Bank earned only $ 48,000. In the last few years, South Shore's profitability has improved, and the bank is now near the industry standard for profit. In 1986, South Shore Bank earned a net income of $ 1,697,000.

An important point which is often overlooked about South Shore Bank is that it does over half of its lending outside of South Shore. In 1984, 54 % of the bank's loan portfolio was leant outside of the neighborhood. This helps to finance the other 46 % of loans, which the bank calls "development loans." This includes all housing, commercial, community organization, and consumer loans in South Shore, as well as student loans.

Over the years, South Shore Bank has chosen to emphasize its development activities at the expense of its goal of providing inexpensive banking services to South Shore residents. It has proven financially difficult for the bank to service large numbers of small deposit accounts and implement its development agenda. Therefore, the bank has raised service charges on its savings and checking accounts to the point where they are the highest of any bank in Chicago.[7] Interestingly, a look at South Shore Bank's 1986 Annual Report shows that service fees accounted for $ 1.57 million in income, while net income for the bank was <u>only $ 1.38 million</u>. Thus, without service fees the bank is in the red.

An analysis of the assets and liabilities of the bank shows that even while fulfilling its development agenda, South Shore Bank is exporting money away from South Shore (see Table 5).In

Table 5: Breakdown of South Shore Bank's Assets and Liabilities by Source, Local and Non-Local.

ASSETS

Total Assets: $ 131.1 million

Local — 29.4 % of assets

Development Loans	$ 35.1 million
Bank premises and equipment	$ 3.4 million

Non-Local — 70.6 % of assets

Non-development loans (assuming these are all non-local).	$ 41.3 million
Securities	$ 51.3 million

LIABILITIES

Local — 63 % of liabilities

Bank deposits	$ 83.1 million

Non-Local — 37 % of liabilities

Development Deposits (these come from outside of South Shore)	$ 48 million

1986, South Shore Bank had $ 131.1 million in assets. Over half of those assets, 58 % ($ 76.4 million), were loans. The premises of the bank, a community facility, is an asset valued at $ 3.4 million, 2.6% of total assets. The remainder of the assets were investment securities, which were mostly U.S. Treasury Securities and securities issued by other U.S. government agencies.

If we assume that 46 % of loans are development loans, which was the case in 1984, $ 35.1 million of the original $ 76.4 million in loans flow to South Shore. Adding development loans plus the value of the bank premises, we see that $ 38.5 million, or 29.4 % of total assets are invested in South Shore.

Since 37 % of deposits are "development deposits" ($ 48 million) we can assume that the remaining 63 % of deposits are from local sources. Thus, $ 83 million of deposits come from local depositors while only $ 38.5 million is invested in the neighborhood. Unfortunately, we don't know how much of the local deposits actually originate from the South Shore neighborhood and where non-development loans have been made. However, this analysis indicates that South Shore Bank, which has a singular local development agenda for a neighborhood bank, exports funds from away from the community.

PART 2. PROSPECTS FOR THE REPLICATION OF THE DEVELOPMENT BANK MODEL IN EAST OAKLAND.

Lessons from South Shore for the Oakland Bank Organizers.

Over the last year, interest in the South Shore Bank community development model has grown throughout the country. Much of this interest has focused on questions of how the development bank model can be implemented in different settings throughout the U.S. South Shore Bank itself recently opened a branch in the Chicago neighborhood of Austin. This branch services the bank's development activities in Austin but does not offer consumer banking services to neighborhood residents. South Shore Bank is also supporting the establishment of a development bank in rural Arkansas, and independent groups are currently raising capital in Brooklyn and Washington D.C. to support the establishment of development banks. The Oakland group can draw on these efforts as well as the South Shore experience to look for ideas to solve the unique problems which they will face.

The following section is a listing of issues which the Oakland organizers will need to take into account as they work to establish the new Oakland development bank. Most of these issues are presented based on what can be learned from what South Shore Bank has done. They also draw from ideas expressed by South Shore Bank management when discussing their neighborhood development model.

Profitability and Subsidized Interest Rates for Single-Familiy Housing.

An analysis of the 1986 Annual Report of South Shore Bank was performed to show the impact on net income caused by a reduction in interest rates for single-family mortgages. This was done to point out the tradeoff between social responsibility, in this case through interest rate reduction, and profit. A second part of the exercise focused on the current housing market in East Oakland, and demonstrated the extent which interest rate subsidies can increase the number of Elmhurst residents who can qualify for single-family mortgages. Thus, the exercise looks at interest rate subsidies from two sides; from the development bank, and from neighborhood consumers.

The analysis shows that South Shore Bank, in 1986, could afford to reduce its interest rate on single-family mortgages by 2 percentage points and continue to earn a profit. A reduction of 3 percentage points would put the bank in the red. If similar reductions in interest rates were implemented by an Oakland development bank with the same cost structure as South Shore Bank, families earning Elmhurst's median income would still be unable to qualify for a mortgage based on a ratio of 30 % of personal income spent on housing. This indicates that a development bank could have difficulty increasing home ownership opportunities for many East Oakland residents.

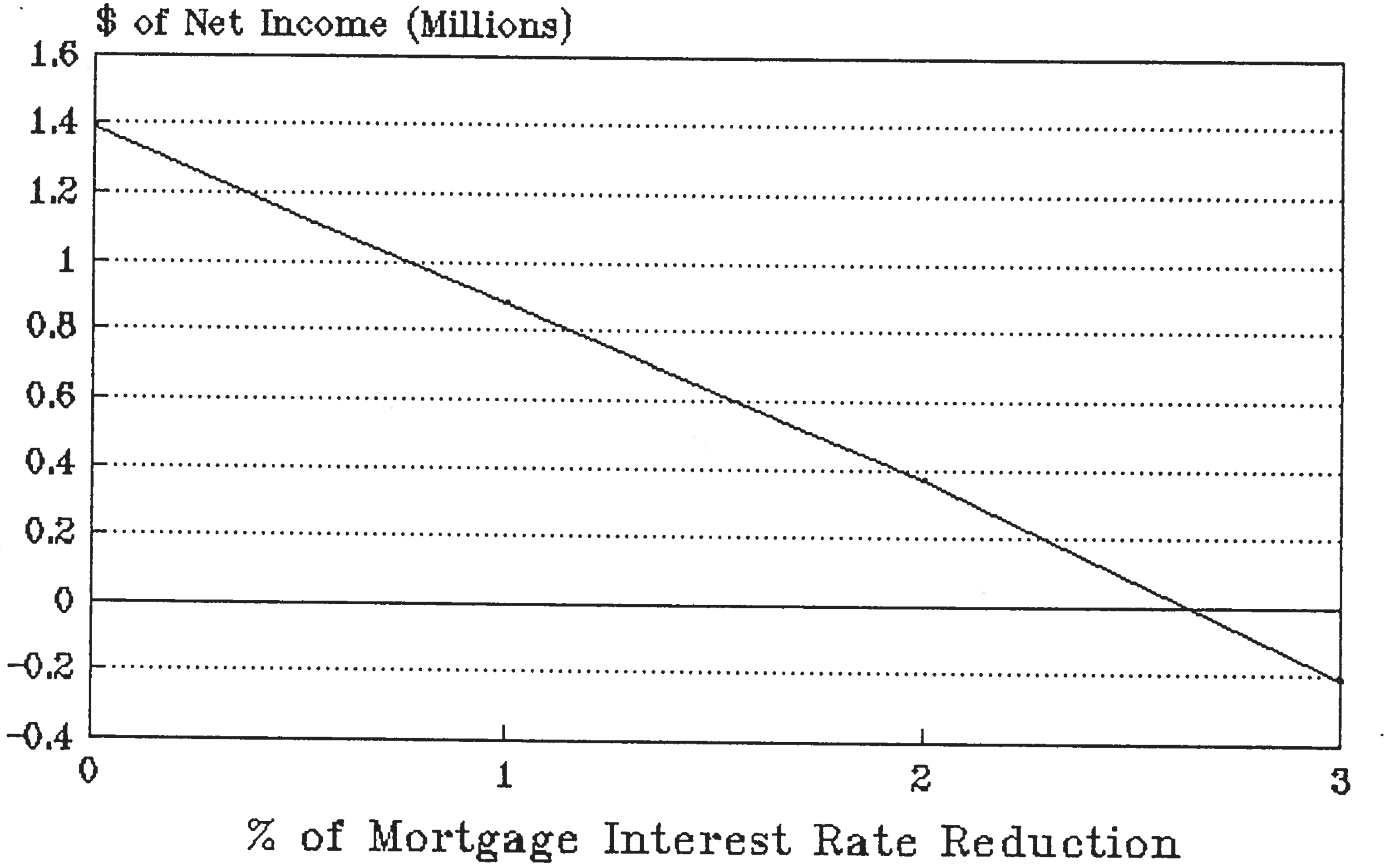
<u>Methodology</u>

A look at South Shore Bank's annual report shows $ 77,377,306 in loans outstanding by the bank at the end of 1986. Multiplying this figure by .01 allows us to find how much income the bank would lose if it reduced its interest rate by 1 percentage point in order to make homeownership more affordable for South Shore residents. The bank earned $ 1,388,668 in net income in 1986. The 1 point is subtracted from interest income earned, leading to a lower before tax income. (see appendix) The after tax income with a 1 % interest rate reduction falls to $ 880,311. A 2 percentage point reduction causes income to fall to $ 371,942, and a 3 % reduction plunges the bank into the red, at -$ 207,651 (see graph 6). The 1986 return on equity for South Shore Bank was 13,6 %. A 1 % interest rate reduction lowers return on equity to 6.34 %. A 2 % reduction lowers it to 3.7 % and a 3 % reduction brings return on equity to -1.9. % (see graph 7).

These figures show the major impact which subsidizing interest rates would have on South Shore Bank's balance sheet in its most profitable year. A brief look at the impact of lowering interest rates in 1977, when South Shore had completed its third year as a development bank, might be more applicable to the Oakland situation as the bank starts up. In 1977, South Shore Bank held $ 29.7 million in loans, and earned a net income of $ 424,000. As 1 % of $ 29.7 million is $ 297,000, a 1 % interest rate reduction would lower the bank's net income to only $ 127,000. The lesson from this exercise is that development activities will have an important impact on the financial bottom line of a development bank, and that these expenditures must be weighed against their potential benefits for the community.

A look at how reductions in interest rates for single family home mortgages affects opportunities for homeownership in

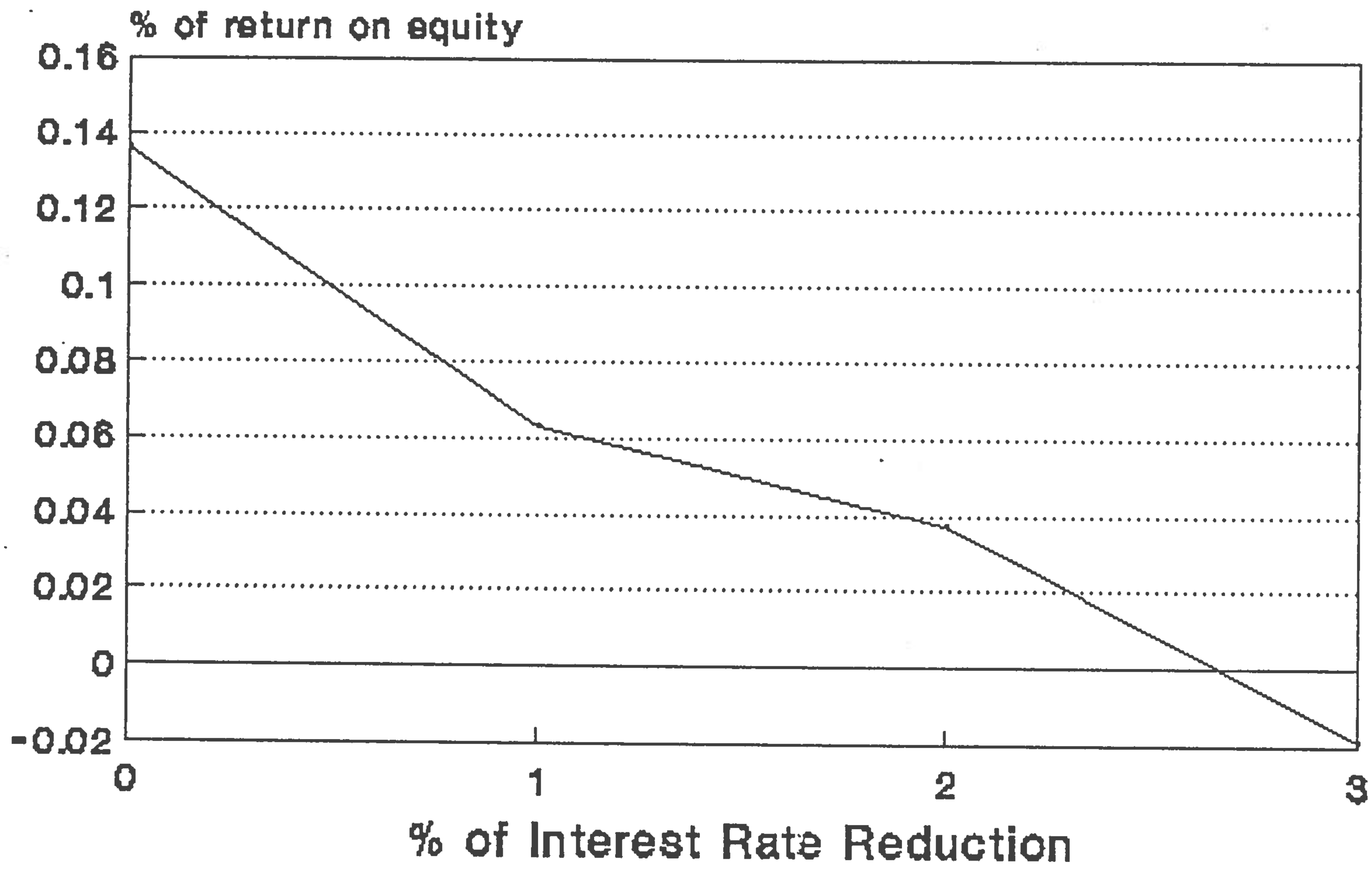
Effect of Int. Reductions on South Shore Bank's Income, 1986.



GRAPH # 6

GRAPH # 7

Return on Equity after Int.Rate Reductions, South Shore Bank, 1986.



(see graph 8).

Thus, even with expensive interest rate subsidies, a family earning the median income in Elmhurst would be unable to qualify for a single-family mortgage from the development bank. This points out the high cost of housing in Oakland, but it should be understood that most homebuyers in Elmhurst and South Shore have always earned above the median income for the neighborhood. In South Shore, many poor people are renters, and in Elmhurst, low income renters plus owners who bought their homes many years ago bring down the neighborhood median income. On the other hand, the assumptions on costs to the bank are based on South Shore Bank's 1986 financial statement, after 10 years as a development bank. An Oakland bank will likely earn lower profits in its first few years, which makes this a more optimistic projection.

This analysis does show that the development bank will be hard pressed to create home ownership opportunities for many Elmhurst residents. Because there are also far fewer multi-family units in East Oakland than South Shore, the development bank will have less opportunities to concentrate on rehab to make major changes in the neighborhood housing stock. Thus, because both home ownership and rehab opportunities are limited, it will be more difficult for the East Oakland bank to package low income housing and neighborhood revitalization as was successfully realized in South Shore.

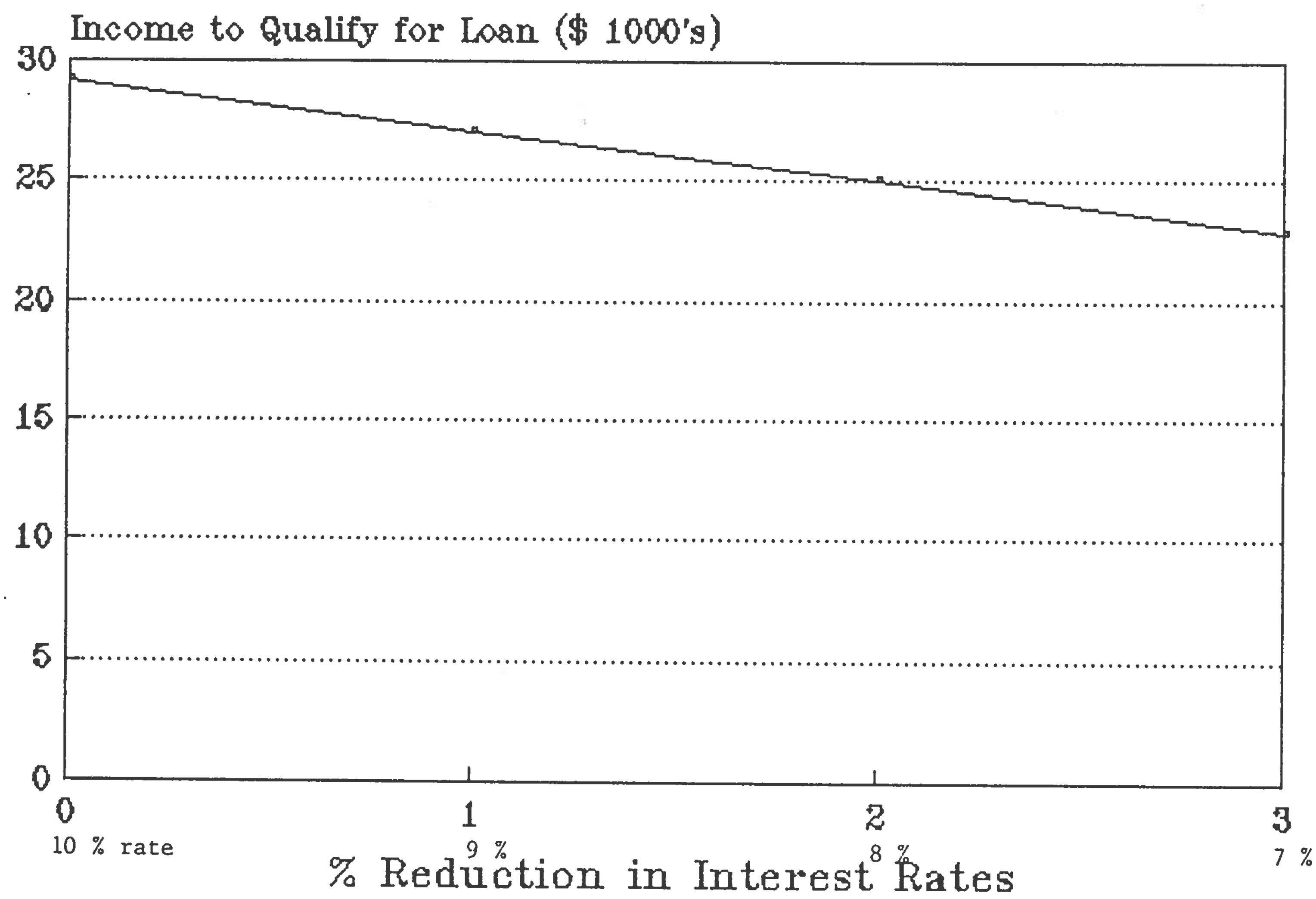
The Importance of Capital.

The greatest obstacle and challenge for the Oakland development bank organizers will be finding the funds to start-up the Oakland bank. The bottom line in establishing a bank is money. Without it, the Oakland bank will never get off the ground.

The first important problem for the Oakland bank is that the Oakland group is planning to start a bank rather than purchasing an existing one, as the current owners of South Shore Bank did. The South Shore management was forced to turn around a declining bank, which had lost 40 % of its deposits over the previous five years. However, they had purchased an institution which had been a fixture in the neighborhood for 50 years, and were able to turn it around. The problem of starting a development bank from scratch is unprecedented. The Brooklyn organizing group is currently trying to start a new bank, and is considering whether or not to wait until an existing bank goes onto the market. The advice of South Shore Bank management is to try to acquire an existing bank rather than starting a new one.[8]

The amount of funds needed for the Oakland group to start a new bank has been estimated to be between $ 5 and $ 10 million. The amount which South Shore Bank was able to raise from individuals and institutions, $ 800,000, is nowhere near that amount. South Shore's new owners were forced to finance the purchase of the bank through a loan from the American National Bank, which put important financial constraints on the

GRAPH # 8: INCOME REQUIRED TO QUALIFY FOR A MORTGAGE LOAN TO PURCHASE AN AVERAGE EAST OAKLAND HOUSE IF INTEREST RATES ARE REDUCED FROM 10 %.



House costs $ 70,000. $ 56,000 loan. Borrower must qualify at 30 % of income being spent for housing.

implementation of South Shore Bank's plans. The Oakland organizing committee will need to develop a strategy for capitalization which relies heavily on large institutional and government investors, and may need to count on spending two years or more to gain start-up funds.

Another issue concerning the feasibility of starting a new bank is that the regulatory requirements set by the Comptroller of the Currency for granting charters to new banks are extensive. A large amount of research and paperwork must be generated, and a Chief Executive Officer must be identified early in the process. The organizers of a new bank would need to hire staff to work towards the establishment of the bank long before it actually opened its doors.

It is also worth considering how the bank will finance its development on a continuing basis. Deposits from within the community will be inadequate to pay for development lending. This is why South Shore Bank began its "development deposits" program, in the hope of finding a source of cheaper, more stable deposits. It is interesting to speculate whether or not the Oakland development bank would enjoy the same access to socially responsible deposits as South Shore Bank, which markets "development deposits" aggressively throughout the country. How deep is the supply of socially responsible deposits? At any rate, it is clear that an Oakland bank will need to look outside its home neighborhood to accumulate funds for development lending.

A final capital issue is that in order to carry out a development program, the bank must lend in a neighborhood which can raise enough capital to repay its loans. If a goal of the bank is to earn a profit, it must be able to realize a return on its investments. While more work must be done to answer this authoritatively, a case can be made to state that East Oakland can generate enough capital and investment opportunities to allow for the bank to operate in the area.

Staff and Leadership in the Development Bank

An important factor in operating a development bank is an experienced, knowledgeable, and innovative staff. According to Shorebank Chairman Ron Grzywinski:

> "Successful development banking requires a highly intelligent staff that possesses sophisticated technical skills that are not readily available. A neighborhood development banker must simultaneously be advocate and judge. He or she must not only be sympathetic to the aspirations of the loan applicant, but must assess the business proposal, judge the person's character, and estimate repayment capacity. Thereafter, this banker must advocate the credit among peers and senior officers, structure and document the loan to satisfy independent auditors, bank examiners, insuring agencies and secondary market purchasers, and then monitor and collect the loan in an orderly manner." [9]

Grzywinski estimates that it takes 18 to 24 months to train an effective development credit officer. This could slow down the growth of a new development bank and increase its costs. Grzywinski believes that experienced traditional bankers with the necessary technical skills are not motivated to work for a development bank.

South Shore Bank has had strong leadership over the years, in part because its senior management came from another bank where they had worked together as a community lending unit. These people combine commitment and enthusiasm with technical skill, and have been able to provide leadership as the development program proceeds. The uniqueness of South Shore Bank's management personnel is debateable. However, their vision is singular, and this probably stems from the fact that they were the organizers of the bank, and strongly demonstrated their commitment by leaving their jobs to manage the bank which they had bought. This is different than what is being proposed in Oakland, where a committee of organizers will hire executives and staff. This will be the test of Grzywinski's belief that it is difficult to attract adequate talent to manage a development bank.

Determining a Development Strategy for an East Oakland Bank.

A major step for the organizers of the East Oakland bank will be constructing a community development plan for the bank. The characteristics of the Elmhurst and Central East Oakland districts call for a different type of program than was put into place by South Shore Bank. While South Shore Bank relied on multi-family housing projects to stabilize targeted areas in the neighborhood, an East Oakland bank should look to other areas, such as single-family housing and industrial development, to have the strongest possible impact on the community.

An East Oakland bank will have difficulty generating the magnitude of neighborhood housing revitalization through the rehab of large apartment buildings which was achieved in South Shore. According to the 1980 Census, South Shore had 24,130 multi-family units out of a total of 34,162 housing units, or 70

%. This compares to 4565 multi-family units out of exactly 20,000 units in Elmhurst, or 23.9 % of all units. In Central East Oakland, 23 % of the units were in multi-family buildings in 1980. Even worse, only 8.9 % of units in Central East Oakland and 5.5 % of units in Elmhurst are in buildings with 10 or more units. This makes the South Shore strategy of concentrating on large apartment buildings unworkable in East Oakland. Finally, the largely single-family housing stock of East Oakland makes the community a far larger geographic area than South Shore, although the size of its population is similar. Therefore, not only are there less multi-family units available for rehab, it will be much harder to geographically concentrate the bank's resources, as was done in South Shore.

Thus, it appears that single-family mortgage lending will be an important part of the Oakland bank's housing program. Unfortunately, while providing funds for single-family mortgages is an important function of the bank, it may be difficult to effectively improve the economy of the community and make a major impact on housing through single-family lending. South Shore Bank concentrated on single-family lending initially to attract capital from other sources to the community. Compared to multi-family, single family lending is more expensive on a per unit basis, provides housing for fewer people, and is a tool for homeownership more often than for renters. Therefore, a higher income group benefits from single-family mortgages than those who gain housing from the rehab of large apartment buildings. Single-family lending is more a tool to promote investment in neighborhoods and attract capital rather than improving housing quality or opportunities on a large scale.

It is also worth considering how the Oakland bank should structure its commercial lending program. South Shore Bank has failed to foster the positive impact it hoped for in its local shopping strips, and there is reason to believe that an East Oakland bank could run into similar problems. First, there is no central neighborhood shopping strip such as 71st Street in South Shore. In fact, Eastmont Mall is the most important shopping district in East Oakland. 71st and Jeffrey is the obvious center of South Shore, and the bank stands at that intersection. It is impossible to find the "center" of East Oakland, and it will be difficult to find an area where the bank could concentrate its resources that will impact the entire neighborhood. While it is likely that small businesses located at Eastmont Mall might have credit needs, lending to these businesses does nothing to revitalize the neighborhood's depressed shopping strips. Ironically, South Shore Bank's new commercial strategy is to build a shopping center in the neighborhood, which East Oakland already has.

Also, in terms of commercial revitalization, the relative small size of South Shore provided South Shore Bank with an advantage which an East Oakland bank would have problems matching. In East Oakland, the shopping areas are spread along wide, long streets like E. 14th. The stores are interspersed with houses and vacant lots. Many of the healthiest businesses are fast food restaurants or auto repair shops. The space between stores and the size of the commercial area they are located in makes the South Shore strategy of revitalization through support to selected businesses less likely to be successful. The spillovers from the supported businesses will be mitigated by the sheer length of strip shopping areas like E. 14th St. and MacArthur Boulevard.

It is also important to attempt to gain a sense of the amount of demand for commercial lending in East Oakland. A U.C. Berkeley class counted 320 businesses in Elmhurst in 1986. We could assume that an average loan is $ 30,000, the average commercial loan amount for South Shore Bank in 1986. If the bank lends to 20 % of the businesses, 64, it creates $ 1,920,000 in debt. In comparison, South Shore Bank made $ 1,642,385 in commercial loans in 1986. This would suggest that there is sufficient demand for commercial lending in Elmhurst, and does not take into account potential lending by the bank in Central East Oakland. What this exercise does not do is quantify how much of this demand is being met by other lenders.

One important opportunity for development which the East Oakland bank can take advantage of is investment in industry. East Oakland has a large industrial district, which is an important source of jobs in Oakland. In 1981, 26 % of all people employed in Oakland worked in the East Oakland (Coliseum) industrial area, and 30 % of all businesses employing over 500 persons were located there. However, there has been an exodus of manufacturing from the district. Since 1973, the area has lost an average of 158,000 square feet of industrial space each year.[10]

Still, there may be investment opportunities for the bank in the Coliseum industrial district because the City of Oakland is targeting the neighborhood as a Redevelopment Area. A co-venture for a new industrial park is ongoing between a developer and a local community development corporation. The area also has excellent locational and transportation advantages for industry.

Industrial development will require expertise never developed at South Shore Bank, since as there is no industry in South Shore, the bank has limited its development activities to housing and neighborhood-oriented shopping. Also, investment in industry may appear to be less "neighborhood-oriented" than support for local housing and small businesses. The bank may come under pressure to insure that its funds are supporting industries with local ownership, or that employ local people, and will need to point out those linkages to its depositors and the community at large.

An East Oakland development bank will need to build a development strategy which will include few of the components of the South Shore strategy. The Oakland bank will need to determine how to plan its housing investment strategy in a setting where multi-family investment opportunities are far more limited than in South Shore. It should also take advantage of the opportunity East Oakland's industrial base affords, and based on the South

Shore experience, should not anticipate major improvements in the state of local shopping strips through loans to small businesses.

Tradeoffs Between Consumer Services and Community Development.

Among many East Oakland residents, there is the perception of a need for neighborhood financial services and community development in East Oakland. Ideally, a development bank could meet both of these needs, but the economics of the bank may force its management to set priorities in these areas. This is due to the high cost of servicing small depositors, which can make it unprofitable for a development bank to offer consumer banking services to the residents of its community. According to American Banker, the cost of servicing a typical checking account is $ 30 per year. If a depositor keeps a low balance, the bank could easily lose money from servicing his/her account unless it imposes fees which make up for that cost.

Since 1983, seven banks and savings and loans have closed in East Oakland. The Bank of America branch at Eastmont Mall, Sanwa Bank at Fruitvale and E. 14th., and an American Savings branch on MacArthur across from Eastmont Mall are the only remaining institutions in the area. This leaves 1 savings and loan and 2 banks to serve 90,000 people in a 35 square mile area. Check cashing centers help fill this void. It may even be that the high rates charged by the check cashing centers are affordable for East Oaklanders compared to the costs of maintaining an account above the minimum balance and travelling to a bank, often in

Alameda or San Leandro. Good services at neighborhood branches also is an issue. For example, Bank of America uses its Eastmont Mall branch as a teller training facility. The branch is often understaffed, and lines are notoriously long.

There are political and neighborhood pride reasons why the East Oakland development bank must be sensitive to neighborhood services. Surely, a new bank, which residents will be asked to support because of the work it does in the neighborhood, will need to offer local depositors a good deal. After the current management bought South Shore Bank, it committed itself to neighborhood services. But once the bank became re-established in the neighborhood, management found itself unable to offer consumer services at low rates, and began to raise service charges.

When South Shore Bank opened its Austin branch, it did it as a credit-only branch, refusing to take deposits there. While this stirred some negative opinion in the community, South Shore quickly financed several neighborhood housing projects through joint ventures with local development corporations, which helped negate bad feeling due to its refusal to take deposits at the new branch. It is interesting to think about the differences between this situation and that of the new Oakland bank. South Shore Bank is able to expand and actually <u>refuse</u> to take deposits from the areas it hopes to do development work in. For neighborhood residents, one of the most attractive benefits of a development bank is its symbolic role as a strong institution which is neighborhood-serving. Whether or not it sees small depositors as a liability, the Oakland bank will likely come under pressure to service them until it becomes well established as a community development agent and develops stable sources of capital.

Affiliates and Community Linkages.

An important factor in the success of South Shore Bank is the work of its subsidiaries, and the link they represent between the bank and the community. In its development activities, South Shore Bank's subsidiaries allow it to undertake complementary functions which the bank itself can not legally or financially undertake. For example, the Citylands Corporation provides the bank with real estate development capability, and the Neighborhood Fund allows the bank to get past the legal restriction against making equity investments in businesses. The Neighborhood Institute offers South Shore Bank the capacity and link to neighborhood people of an active community organization.

In Oakland, a new development bank will be asked to work with existing community development agencies and organizations rather than working to create new organizations as South Shore Bank did. The interaction between the bank and local organizations could create political and operational problems, and adds an element of uncertainty to the bank's relationship with the community that South Shore Bank was able to avoid. The difficulty of working with unaffiliated local groups was raised by Mary Houghton, who called each joint venture with an Austin CDC "politically painful."[11] The new East Oakland bank will need to deal with these concerns, as local neighborhood groups will be quite important in working towards the bank's creation, and building its initial deposit base.

Beyond the fact that the Oakland development bank will be forced to work with existing organizations in East Oakland, there is a question as to whether affiliates are necessary to the success of a development bank's neighborhood agenda. Affiliates allow South Shore Bank control over the entire development process, from project proposal to management, and offer the bank a strong presence among neighborhood residents. South Shore was unable, for financial reasons, to start-up its affiliates until 1977, five years after the bank was purchased. Bank management has also stated that Citylands, the development affiliate, was far undercapitalized when it packaged its first project in 1979. Based on the South Shore Bank experience, it will be several years before the Oakland bank will be able to afford to establish affiliates. On the other hand, the bank has opportunities to do joint ventures with existing development corporations, and can work to strengthen community organizations which are already in place. While the Oakland bank may have the same concerns which South Shore Bank had about the capacity of local organizations, the opportunity to create meaningful links to the neighborhood through existing organizations should be explored.

Conclusion

While the development bank model has been successful in South Shore, chances for its replication in Oakland appear dim. Numerous ingredients are necessary to start a development bank, and thus far, South Shore Bank is the only place where they have come together successfully. These ingredients include the following:

* An existing bank to purchase. The time, expense, and difficulty in attracting investors to capitalize a new bank make it extremely unlikely that a development bank comparable to South Shore Bank could be started from scratch.
* Access to large amounts of capital. Bank organizers will need to be well financed to purchase an existing bank. The healthier the bank, the more expensive it will be. Thus, like in South Shore, bank organizers may be forced to buy a troubled institution and work to turn it around.
* Sources of funds from outside the community. A development bank must formulate a strategy to supplement its deposit base, in order to maintain a stable source of funds, and assist in financing its development agenda.
* A committed, experienced, and effective staff, management, and board.
* Strong ties with the community and cooperative relationships with local organizations.
* A realistic plan for community development in the target neighborhood.

* A well-defined mission for the bank. Is the bank's role to provide community banking services or neighborhood development?

With sufficient amounts of time and money, it is possible that many of the above conditions could be met in East Oakland. However, the difficulty of doing that makes the question of alternatives to a development bank worth considering. There are numerous ideas of how a permanent capital source and outlets for consumer banking services in East Oakland could be established. These include starting a credit union, a Minority Enterprise Small Business Investment Corporation, and a trust fund which could provide capital for community development projects, These efforts may offer an easier road to achieving the goals of a development bank than attempting to create one.

1. Woodstock Institute. Evaluation of the Illinois Neighborhood Development Corporation. Department of Housing and Urban Development, Germantown MD., 1982, p. 21.

2. Woodstock Institute. Evaluation of the Illinois Neighborhood Development Corporation. Department of Housing and Urban Development, Germantown, MD., 1982, p. 21.

3. Barnard, Judith. "Money Matters." Chicago Magazine. February, 1977.

4. The Woodstock Institute. Evaluation of the Illinois Neighborhood Development Corporation. p. 8.

5. Ibid. p. 8.

6. The South Shore Bank of Chicago. Community Reinvestment Act Statement. Chicago, 1987, p. 8.

7. Interview with Professor Richard Taub, University of Chicago, 1/17/88.

8. Interview with Mary Houghton, President, Shorebank Corporation. 12/29/87.

9. Grzywinski, Ronald. "Banks and Community Renewal." Shorebank Corporation, Chicago, 1987.

10. Office of Economic Development and Employment, City of Oakland. Coliseum Area Development Program. Oakland, 1982 p. 21.

11. Interview with Mary Houghton, President, Shorebank Corporation, 12/29/87.

Appendix

This page shows how the impact on South Shore Bank's net income was determined if given percentages of interest income are deducted. The lost interest income corresponds to lost income if interest rates are artificially lowered below market rates to make home purchases cheaper for potential borrowers.

The change in interest income represents a 1 point reduction in average interest rates.

$ 77,377,306 <u>Total Amount of Loans</u>
* 1 % = $ 773,773

so subtract $ 773,773 from $ 12,697,750 which is <u>interest income for 1986.</u> = $ 11,923,977

	-$ 6,298,114	Total Interest Expense
	-$ 785,000	Provision for Loan Losses
	+$ 2,011,108	Total Other Income
	= $ 6,851,971	
	-$ 5,512,076	Total Other Expenses
	= $ 1,339,895	
	* 34.3 Tax Rate	
	= $ 880.311 After Tax (net income)	

The calculation is the same for each additional interest point subtracted. If 2 % is subtracted, multiply $ 77,377,306 * 2 % = $ 1,547,546, then work through the above calculation.

To determine the monthly payment for a typical Elmhurst home:

Assume a home which sells for $ 70,000.
To purchase, an $ 14,000 down payment is required. Thus $ 56,000 must be borrowed.
Assume a 10 % mortgage interest rate. 30 Year Fixed Rate.

The median family income in Elmhurst was $ 13,330 in 1980.
5 % inflation per year brings the median income to $ 19,690 in 1988.

To figure out housing costs. Take mortgage payment + property tax (.0124 * the price of the house) + insurance/maintenance allowance. (mo. payment * 4/12, according to First Nationwide Savings).

For a $ 56,000 loan at 10 % interest.

mo. payment = $ 495
+ $ 165 insurance/maintenance
+ $ 72 property tax
<u>= $ 732 TOTAL MONTHLY HOUSING PAYMENT</u>

For a resident earning the Elmhurst median, $ 19,690:

$19690/12=$ 1640 $ 732/$ 1640 = 44.6 % of income going for housing.

The same calculation is performed to see what percentage of income a family earning $ 25,000 pays each month for housing.

Another calculation yields an approximate income which must be earned to qualify for a loan at 30 % of income being spent on housing.

The same calculations are done for home purchases at 8 and 7 % interest rates.

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