

# ON SHOREBANK AND BUMBLEBEES

By Lynn Pikhholz and Ronald Grzywinski (South Shore Bank)

*"Now here you [Shorebank] are, flying like a bumblebee – which has mathematically and scientifically been proven NOT to be able to fly, and yet it flies"*

*"So are you [Shorebank] an exception or is there something systemically pertinent about what you have been doing for the past 25 years that policy makers cannot just push aside like a mere curiosity?"<sup>1</sup>*

Everyone, except the bumblebee itself, knows that a bumblebee can't fly. Its wings are not large enough. Aerodynamics declares it is scientifically impossible. The greatest computers in the world all come to the identical conclusion; it cannot fly. But what does the bumblebee do? It ignores the great minds, the skeptics, the computers... and it just goes ahead and flies.<sup>2</sup> A statement like this is easily used as a springboard for many lessons: Why not one on community development lending?

Shorebank Corporation is a bank holding company that invests in and works at restoring markets in underserved communities. With assets of \$900 million and \$79 million in capital, Shorebank invested over \$100 million during 1998 through its own commercial banks and other subsidiaries in five U.S. locations to demonstrate that lower-income communities are worthy of additional private and local investment, even by stringent private sector standards. Shorebank's investments generate external awareness of untapped market potential in less affluent communities. Shorebank is committed to a business-driven approach to community economic development. We base it on our belief that alleviating poverty requires creating wealth, and that wealth is created best when businesses identify and invest in neighborhood assets. Too often, we undervalue assets in economically distressed

<sup>1</sup> Comments received by the authors from Christophe Guene of Inaise in February 1999.

<sup>2</sup> Adapted from an electronic reprint of Entomology Notes # 10, Michigan Entomological Society

neighborhoods which offer sound business opportunities to businesses and banks willing to look for them.

## **Undercapitalized, overleveraged and idealistic four individuals acquired South Shore Bank**

Shorebank's founders, a group of four bankers, began seriously questioning the conventional wisdom that bumblebees don't fly in the late 1960's.<sup>3</sup> They began a successful minority small business loan program at a bank in Chicago. The program out-performed similar large bank programs and Shorebank's founders began exploring the potential of broader private sector approaches to urban problems. In 1972, the Federal Reserve Board observed that Bank Holding Companies, "possess a unique combination of financial and managerial resources making them particularly suited for a meaningful and substantial role in remedying our social ills."

We believe this is true. Banks have a large number of attributes that make them particularly attractive as the core of a community development institution. As a regulated, large-scale institution, a bank is known, trusted, legitimate, well capitalized and self-sustaining. A bank possesses unusual capacity to be continuously knowledgeable about the neighborhood economy. And a bank can convert ordinary deposits into development loans; through doing so, it leverages its capital approximately 14 times! As a regulated business, the bank is forced to work to a bottom-line discipline that ensures a focus on being effective and efficient.

Shorebank's founders decided to translate their beliefs into a banking institution. Undercapitalized, overleveraged, and idealistic they acquired South Shore Bank with \$800,000 in equity capital and a \$2.5 million equity loan. Shorebank began operations in 1973 in South Shore, a community of approximately 80,000 people on the south side of Chicago which had virtually gone from all white to

<sup>3</sup> Ron Grzywinski, a co-author this paper, is one of Shorebank's four founders and is currently serving as the CEO of Shorebank Corporation.

all black within the prior decade, a familiar scenario at the time in many areas of urban America. At the time the founders took over the bank, almost everyone had stopped investing in the community, and the last remaining bank, South Shore Bank, was trying to move out.

**For the first four years, the best and the brightest bankers ignored us**

Like the bumblebee, everyone believed Shorebank would fail. For the first four years the best and the brightest bankers ignored us. We could not hire anyone with banking experience because no one believed a job with us had a future. Since Shorebank's humble beginnings, total assets have grown 15 times to \$900 million and total capital has grown 95 times. Shorebank today consists of 22 affiliated organizations in five locations with 500 employees. Our four commercial banks in the U.S. are all fully regulated institutions. Shorebank's other subsidiaries and affiliates include for profit real-estate companies; not-for-profits that do higher risk enterprise lending and labor force development; and venture capital funds. Shorebank also has a consulting company, Shorebank Advisory Services, which works with for-profit and non-profit organizations both locally and abroad and has been instrumental in assisting conventional banks, both domestically and internationally, tap into new market opportunities which have both profit and development-impact potential.<sup>4</sup>

**Since '73 Shorebank's assets have grown 15 times and capital has grown 95 times**

From the early eighties until our recent expansion into three new states in the nineties, Shorebank's return on common equity averaged 25% and the return on total average capital for the same period averaged 13%. Mostly as a result of our three start-up bank holding companies, Shorebank Corporation ended the most recent five years (ending on December 31, 1998) with consolidated earnings averaging only \$0.2 million, and the return on shareholders' equity averaged 0.002%.

South Shore Bank, our oldest commercial bank in Chicago, has been the "earnings engine" of the Corporation throughout the history of Shorebank. Since 1973, the Bank has produced cumulative

profits in excess of \$36 million. Nearly \$15 million, or 40%, of those earnings were generated during the past three years.

**South Shore Bank is our earnings engine**

In 1998, South Shore Bank (SSB) generated record earnings of \$6.2 million – a 21% increase over 1997. In 1997, South Shore Bank's results were similarly impressive at \$5.1 million – a 45% increase over 1996. South Shore Bank's lending in economically distressed neighborhoods in Chicago has increased around 15% over each of the past two years. The majority of this lending is in multi-family rehabbing, and small business lending. The bank's loan loss reserves to total loans ratio is 1.7% (peers are at 1.4%) and charge-offs are at a historic low of around 0.37% (peers at 0.3). Historical average charge-offs for the past 12 years have been 0.56% (peers are at 0.5%). For the past 25 years, average charge-offs are around 0.6%. The leverage ratio of the bank is 6.2% and the loan to deposit ratio is 66%. South Shore's return on equity (excluding goodwill, which distorts the number because of our recent acquisitions) is 18.98%. Including goodwill it is 11.78%.

South Shore's lending portfolio is split more or less equally between commercial lending, which is almost exclusively to small businesses (over 99.9%), and real estate lending. South Shore Bank's small business and real estate portfolios have been consistently profitable. How do we do it?

Certainly, for the bumblebee, there is a lot of weight for such little wings. So, how does *it* do it? The most compelling theory we found (with some application to community development banking) lies in the fact that static objects are governed by different stability laws than dynamic objects. For example, take a bicycle. As a static object it is not stable (like a tricycle would be). Leave a bicycle standing without support and it will fall over. However, a moving bicycle is perfectly stable, and it is easy to explain why with basic physics. The bumblebee is the same, as a static object it is not aerodynamically stable, it cannot glide. But when it is flapping its wings, we're into a whole new ball game for how air moves around it.<sup>5</sup>

<sup>4</sup> Lynn Pikholtz, a co-author of this paper, works as a Corporate Analyst at Shorebank Advisory Services, Shorebank's international and domestic consulting company.

<sup>5</sup> Adapted from an electronic reprint of Entomology Notes # 10, Michigan Entomological Society

### Shorebank achieves its development goals on a sustainable basis

Sitting statically at a desk, it is very easy to call community development lending unprofitable and not the domain of 'good business'. When we start flapping our wings a little and examine real opportunities that exist in less-affluent neighborhoods, our language quickly changes from charity and subsidies, to investment and market opportunities. The numbers on South Shore Bank's lending and financial performance clearly suggest that it is possible to transcend the worn out and superficial contradiction between business and charity, between development and profit. Shorebank is achieving development impact on a sustainable basis. The switch in Shorebank's capital base over the years is further evidence of the shift in private sector perceptions that development banking can generate returns and 'do good' at the same time. Common equity has grown to 98% of total capital. Today, a diverse group of investors including a growing number of major banks, insurance companies and other businesses make up the majority of our shareholders.

Shorebank's founders were convinced that the goal of development banking is to attract and combine the resources necessary to build a critical mass of permanent development activities sufficient to restore community and investor confidence, changing the dynamic of spiraling decline into a self-sustaining process of renewal. Our experience and the experience of other major banks in the United States now confirm several core beliefs about this process:

#### Many ordinary residents in distressed areas are credit-worthy

→ First, many people in distressed communities desire to improve their own life conditions and, although they may lack conventional credit histories, many of these ordinary residents are fundamentally credit-worthy.

→ Second, local development capacity, whether in the form of small scale, locally based entrepreneurs, fledgling business entrepreneurs, or community development corporations, need to be supported in a disciplined, business-like fashion. Positive community development is a long-term partnership between residents who care about their communities and financial institutions with similar motivations.

↘ Third, market forces can be restored in under-invested communities if the level of institutional capacity is sufficient to the task at hand. Permanent, self-sustaining institutions must be created. The problems occurred over decades, and require long-term, permanent solutions. This cannot be a "quick fix".

↘ Fourth, <sup>10/11/95</sup> an array of complementary interventions is often necessary to reverse disinvestment. The multiple, complex, mutually destructive problems confronting disinvested communities regularly require an equally comprehensive set of mutually reinforcing tools. These allow synergies to be achieved, such that activities, which would not be viable in isolation, can succeed together.

↘ Fifth, successful restoration of market forces requires that revitalization be targeted to clearly identified geographic areas and markets with the potential for renewal. Targeting allows an institution to develop the necessary specialized market expertise, allows controlling risk and transaction costs, and assures that investment will be concentrated in order to achieve critical mass.

#### A bank must be responsive enough to allow it to generate and broker development deals

Finally, to succeed, the institution must be close to and driven by its markets. It must be innovative, flexible and customer driven, based on relationships of mutual discipline and accountability. A bank must be close enough, specialized enough, and responsive enough, to allow it to identify, generate and broker development deals with manageable risk; and it must have the credibility to build partnerships and leverage outside resources.

The bumblebee is one of nature's most adaptive creatures. They are excellent pollinators because many parts of their body have become adapted for this purpose. They can fly at much lower temperatures. They have longer tongues to reach flowers with long, narrow corollas and their hairs are branched and are perfect for picking up and transferring pollen. Bumblebees would die without flowers and many flowers would be unable to breed without bumblebees.<sup>6</sup>

South Shore Bank (SSB) was our first bumblebee and the local entrepreneurs in South Shore were the flowers that needed juices to produce. In every

<sup>6</sup> ibid

society, these small and medium sized businesses make up the sector which creates jobs and is the fertile soil from which entrepreneurial innovation and expansion sprouts. Without these businesses, many banks in the long run, would die. Shorebank saw that the profitable provision of financing services to this sector as a great market opportunity.

#### **Local rehabbers risked their own savings to purchase buildings using loans from SSB**

Shorebank's best-known enterprise support program that it operates profitably through its commercial bank in South Shore, is its multi-family mortgage loan program which finances residents in the business of rehabbing apartment buildings in economically distressed areas. This unconventional approach to entrepreneurial development created a profitable lending niche for South Shore Bank; it also created successful businesses, and resulted in visible development benefits. The local residents realized real estate appreciation and improved, secure, affordable rental housing. The primarily African-American building owners realized an increase in wealth.

The stage for a successful credit program in South Shore was set in 1975 by a consortium of savings and loan associations who -- at Shorebank's aggressive urging -- undertook a 300-unit, publicly financed, scattered site rental housing rehabilitation project in South Shore. The project demonstrated strong market demand for the highly attractive rehabilitated, secure and affordable rental properties. Local investors then proceeded to invest without subsidy, risking their own savings to purchase other buildings, with South Shore Bank financing them.

Local rehabbers succeeded by acquiring undervalued assets (apartment buildings in a neighborhood that had undergone racial change) and investing in their upgrade cost effectively through shrewd purchasing of materials and use of their own and other available labor. They took advantage of the strong market demand for safe and affordable housing. In essence: the market was right; they had the skills and drive; and they matched their motivation with a huge time commitment (true sweat equity) and dedication to their business of rehabbing.

#### **South Shore Bank tailors its loans to meet customer needs**

Two other factors were critical to their success. First, rehabbers were able to manage their unsubsidized finance because of the way South

Shore's lenders creatively structured their loans. This was very different from the technician-style asset-based approach of many other commercial banks. Second, rehabber learning took place through informal information sharing and as well formal meetings among fellow entrepreneurs.

South Shore lenders tailored the loans to meet customer needs. The loan program operated simply, without construction escrows, lien waivers for contractors or much paperwork. The financial economics of most of South Shore's customers would not have allowed them to abide by these rigidities. Payment arrangements need to be more flexible. This approach fits the pragmatic style of most borrowers, the deal's inability to afford much in soft costs, as well as with the personality of South Shore Bank's chief lender, Jim Bringley. Jim and most of Shorebank's lenders have a disdain for bureaucracy and a passion for interactive customer contact, both in meeting the borrower's financial needs, and "collecting hard and fast" when the borrower slips on a scheduled payment.

#### **If a borrower comes in with promise, we make the deal work**

South Shore's mandate to its lenders was simple: "If a person comes in with promise, make it work." Loans were structured to fit the borrower's cash flow. This sometimes meant an initial six months moratorium of principle payments; approving loans with an additional amount for working capital to fund early bank repayments, or offering a line of credit to buy a property quickly and cheaply from a desperate seller.

South Shore Bank's lending department also facilitated the sharing of information among rehabbers. This took place through rehabber networks started by a modest bank effort to aid information sharing. The local rehabbers in South Shore knew of one another's skills and reputation but did not meet with one another on any structured basis.

#### **Entrepreneurs learn best from other entrepreneurs**

South Shore Bank's chief lender understood that the rehabbers could benefit from interacting with one another. He knew the local rehabbers since many had taken loans at the Bank. He offered them the bank's boardroom as a place to meet on Saturday mornings to talk about issues of common interest. He knew the fundamental truth that entrepreneurs

learn best from other entrepreneurs. They believe someone who has already done something that has worked.

Half the attendees at these meetings were proven operators; half were novices. The rehabbers who had done well had credibility. So if one of them said "hey, don't get that type of boiler or use Jack's Boiler Company to fix that specific problem, or get this particular part," the others listened and learned. In more recent years, the rehabbers run their own meetings at a local Mc Donald's restaurant. We never served hamburgers.

South Shore Bank's lenders also assist borrowers by advising them when they might be overpaying for a property. Assisting a borrower not to overpay means the loan will be better able to fund needed rehab work. The lenders also gave advice on alternative and incremental rehabbing options, especially if borrowers did not have much extra cash on-hand.

Our real estate department likes to grow with its customers for as many decades as possible. It prefers first-time rehabbers to start with a small building which is a good fit with their existing capacity and then to grow with them as they develop more competencies in the real estate business. If, for example, a rehabber has never done a project, we would want to finance a less sophisticated rehab scope (e.g. repairing job; redo floors; put in new mailboxes or new windows and frames) on a six flat. For bigger apartment buildings with large rehab needs, South Shore's lenders prefer rehabbers to show that they will devote significant time to the project. If they are not already working on the rehab full-time by the time they are doing 36 unit rehabs, they should demonstrate that it is their intention to do so in the future.

#### X Large U.S. banks now compete to make loans to local rehabbers

Shorebank's rehabbing initiatives contradict the traditional banker's "bigger is better" idea of business. The cumulative impact of rehabbing has resulted in: job creation; safe and affordable housing; and presumably a better quality of life for residents. It has brought more mainstream investors into the area. Large banks now compete to make loans to rehabbers. And local rehabbers have built up both equity and skills to undertake larger scale rehabilitation. Today, dozens are engaged in extensive rehabs of large 3 story, 24-36 unit brick buildings. Without a penny of subsidy, the finished

product is a truly beautiful building that is safe and affordable at between \$450 (one bedroom) to \$550 (two bedrooms) to the typical tenant, a young woman with two children.

Two full-time equivalent loan officers currently finance the rehabilitation of 75-100 buildings a year in South Shore alone. That's about \$10 million/year/lender with an average loan of \$250,000 and with some rehabbers getting loans in the \$1 million plus range.

South Shore Bank now operates in 13 designated neighborhoods of the Chicago City, home to nearly half the city's African-American population. Demand remains strong in our initial neighborhood 25 years later and is growing in the neighborhoods closest to the lenders. In 1998 we did around \$50 million in real estate housing deals, \$21 million in single family and \$30 million in multi-family. Cumulatively, our real estate entities have done over \$500 million in our target neighborhoods company-wide. The loss rate on these loans is low by bank industry standards and the portfolio contributes substantially to the bank's profitability.

Shorebank began doing its first mortgage on single family rehabs five years ago. And, only two years ago, as a result of our expansion into a new locality with huge tracts of vacant land, we began lending for new construction. Our total real estate portfolio is around \$200 million in Chicago, of which single family deals make up 35%. Like for our multi-family lending, we do not use much subsidy or insurance for our single family deals. Mostly, private mortgage insurance companies' dictates like the restriction that a borrower cannot have more than 30% of the purchase price of the first mortgage allocated towards rehab, simply don't make sense for us or our borrowers.

We cover our increased exposure with a 1% fee to borrowers. This is the same price that the insurance company would charge borrowers. The average single family rehab deal is \$85,000. This price includes purchase and renovation. Borrowers usually put down 3%, but this is flexible. Our loans are usually fully collateralized and we generally do progress payments and advance only a portion of the money upfront. For first-time borrowers this is especially true.

**Our lenders take the deal the whole way through**  
We differ from conventional banks in that our lenders take the deal "the whole way through". At Shorebank, the lender is the one who meets the customer for the first time, goes to visit the property, does the application, the underwriting, and manages the property appraisal. He or she also goes out for progress payment checks and follows up immediately on any late payments. Conventional banks often have three people doing different parts of the same deal and the underwriter may never meet the customer. Each of Shorebank's lenders has underwritten lots of differently structured deals in our selected neighborhoods. As a result, they are better able to make judgements for each new deal that walks through the door. The same appraisers do all our deals for similar reasons. They know real comps (comparable property prices) and are able to give meaningful and valid appraisals. They know how the value will change on a particular street corner if the floors are sanded and a gate is installed. They are able to advise us, and we, in turn, advise our borrowers. Our deals are incredibly customer intensive with a lot of face-to-face contact.

**You become a paper pusher instead of a deal maker when you rely too heavily on subsidies**

It may seem strange to some that we choose not to take advantage of available credit enhancement products and subsidies available for the Bank's real estate products. Abiding by the restrictions and bureaucracy of government requirements would require that we push paper the whole day (adding to our cost structure), rather than doing deals. There would also be controls on South Shore Bank's borrowers, for example, who they are allowed to hire to do the job. This adds to their cost structure too. Even if these subsidies did not have all the negatives, it is doubtful that they could have ever been provided at the rate and scale that we would have required them. Since the early eighties the work of these local entrepreneurs has affected well over a third of our first neighborhood's 24,000 units of rental housing in South Shore. Subsidies are simply not ever generated on this scale - a scale that we believe to be necessary to achieve an impact at neighborhood level.

A logical question, then, is how South Shore Bank makes these housing loans for poor people living in distressed neighborhoods without subsidy, and still makes a profit. First, we do not have all the higher costs that often accompany government subsidies. Second, we assist our customers in getting good

prices for their deals. They may buy a typical abandoned building for \$5,000 a unit and put in \$12,000 for rehab. This makes a quality product affordable for really low-income residents. South Shore Bank does not usually finance more than \$25,000 of debt in a unit. In other cases, the housing stock is in relatively good shape and a small investment adds substantially to the value. Third, South Shore's borrowers use highly skilled contractors who get the job done at below market cost. Sometimes, for example, these are plumbers who may be working for the City by day, and moonlighting at a cheaper price at night. Fourth, we structure the deals to fit the cash flow of our borrowers. And fifth, we structure correctly for the risk because we know our neighborhoods really well. We are probably one of the only banks that does not stick by any debt-service ratio rule. But we are careful and realistic in our projections about the future profitability of the buildings that we finance.

It may sound like Shorebank is anti-subsidies. To the contrary, much of our development work would not have been done as profitably without government programs. Our real estate housing development affiliate uses low income housing tax credits. Our not-for-profit companies use job-training funds. And our banks have deposit insurance and use Small Business Administration (SBA) guarantees and the State's Capital Access Program.

**We are cash flow lenders**

South Shore Bank's small business lending niche is with neighborhood businesses that are often poorly capitalized and who are vulnerable to economic downturns. Many have sales below \$1 million and the vast majority of South Shore's borrowers have annual sales below \$5 million. The remainder almost all have less than \$10 million in sales. Clearly, these are not mom and pop micro deals.

We are cash flow lenders. Shorebank's borrowers sometimes do not have much collateral or management experience and their earnings history is often short or non-existent. Yet, they are capable entrepreneurs who we believe will succeed. They are credit-worthy and fully bankable if the deal is structured to fit their cash flow and their ability to manage debt.

But lending is more people-intensive and risks are higher; both because of the lack of sufficient collateral and a long earnings or management track record. This is especially true for start-ups. This

means that losses may be higher, and banks, like us and like you, want some protection. It is for this reason that the government credit enhancements are so important.

**But many of our small business deals wouldn't have been done as profitably without subsidies**

The US government's credit enhancements do work. And they work because they are smartly structured to provide enough incentive for banks to do small business lending deals, and enough disincentive to ensure that the deal make sense. In the case of the federally funded Small Business Administration (SBA) subsidy program, banks are insured up to 75% with a cap of \$750,000. In the case of a default, banks will pay a 25% loss on a pro rata basis. Although individual losses may be small, they add up. If South Shore Bank does approximately \$10 million a year in SBA guaranteed small business deals; even with a 75% SBA guarantee we would still have 2.5 million dollars at stake. We thus have an incentive to "lend smart." On the other hand, we can make a \$1.5 million loan to a single small business in our target area and we are still guaranteed for 50% of that amount just in case things go wrong and the business suffers a loss. SBA's historical average loss rate is 7%. This is reasonable given the market that it is catering to. After all, if we expected the SBA to have a 2% loss rate like any other bank, there is no need for SBA to exist at all.

South Shore and the experience of other banks show that profits can be made making SBA guaranteed loans. Surprisingly though, seven out of the fifteen largest SBA lenders in the country are non-banks like General Electric, AT&T and the Moneystore. These businesses do SBA lending purely to make profits. This begs the question of why traditional banks, who are under pressure to do community development lending are not using it more. One guess is that there is often a fundamental mistrust between government and banks. Often a misplaced and misguided mistrust. Second, there is an assumption that borrowers, who look "different" on paper, are less credit-worthy. Third, SBA and similar subsidies require lots of paperwork and bankers need to invest time to understand all the intricacies. Bankers do not naturally have any inclination for this type of effort. A more recent government incentive program in the U.S. called the Capital Access Program overcomes many of SBA's

shortfalls and has been favorably received by an increasing number of major banks.<sup>7</sup>

**We may know derivatives, but we have been left in the dust by bankers in developing countries**

Jane Jacobs, a well known North American urban development specialist once said at a small business symposium in Canada that: Westerners like us have no difficulty creating sophisticated financial products like derivatives, but that we have been left in the dust by the Latin Americans and Asians who have figured out how to deliver loans of several hundred dollars to uneducated entrepreneurs who cannot present credit reports or financial statements, profitably. The point Jane Jacobs and many others have since made, is that smaller deals at market interest rates to less affluent people in less affluent markets *do* work if they are structured to suit the borrowers, their cash flow, and their ability to manage the loan. Not only do they work for borrowers, but they are profitable for traditional banks and are the fodder of far more lucrative business deals for banks in the future.

And now, to end our bumblebee session... We are not saying that lending in economically distressed areas is easy. But for those bankers that are open to seeing the business opportunities for making sound investments in economically distressed areas, the potential for both profit and development impact is enormous, and there is increasing evidence from players worldwide that this is the case. Bumblebees (in the plural) do fly. And as the economist John Maynard Keynes would have said if he was around at the time that the first bumblebee took its flight, "in the light of the evidence, I have changed my mind." May all serious bankers do the same.

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**Post Script<sup>8</sup>:**

If you should ever find a grounded bumblebee early in the year, just at the start of the first warmer days, then it is probably a queen. She may have been caught out in a sudden shower or a cold spell. If the temperature of the thorax falls below 27 °C the bumblebee cannot take off. The best thing you can do is to pick her up using a piece of paper or card, put her somewhere warmer, and if possible feed her. When she has warmed and fed she will most likely

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<sup>7</sup> For more information on the CAP, see "Capital Access Programs: A Summary of Nationwide Performance," Department of U.S. Treasury October 1998.

<sup>8</sup> Adapted from an unsourced internet site.

fly off. You can feed her using a 30/70 mixture of honey and water in a pipette or eye dropper or simply by putting a mixture of honey and water on the table, but be careful not to wet her hair or get her hot and sticky. By saving a queen you may have saved an entire nest.