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Too Small to Save: Did the nation's largest community bank collapse because of its social-justice mission -- or its financial ambitions?

By Tim Fernholz

Location is everything, especially in Chicago, where your neighborhood isn't just where you live but who you are. Rahm Emanuel, running for mayor, can't get any respect because he grew up in the suburbs. Barack Obama, Senate hopeful, won in part because he had liberal credibility from his home on the South Side and was able to raise money on the North Side. Politics and real estate can make an unsavory combination: More than one Chicago politician, including Obama, has found himself in hot water after accepting real-estate favors from politically interested friends.

But Chicago also has a tradition of attempting to ensure location isn't everything -- at least when it comes to getting a loan or a job. The city's South Side was, until very recently, home to ShoreBank, the nation's largest community-development bank, with over \$2 billion in assets. During the course of its 37-year existence, it invested millions in underserved, minority neighborhoods, with nearly 80 percent of its lending focused on low- and moderate-income communities. The bank was founded in the 1970s, when other banks fled its target market, poverty-ravaged South Side. ShoreBank measured success not only in profit but also in its ability to build wealth in low-income communities and invest in environmental sustainability. This triple-bottom-line mission demanded special standards: ShoreBank made loans to people that other banks would perceive as credit risks and emphasized financing green projects. The bank was more than a do-gooder -- it was a profitable business. Its local knowledge gave it an advantage in evaluating borrowers other banks wouldn't give a second look.

ShoreBank became a symbol of community-development finance -- politicians associated themselves with the bank, and other financial institutions modeled themselves after it. Federal legislation sought by progressives during the Clinton administration gave government support to organizations like ShoreBank. These Community Development Financial Institutions (CDFIs) must make a large percentage of their loans in underdeveloped low-income areas, and in return, receive tax breaks and access to special development funds.

The institution seemed to do the impossible, lending money at profit without exploiting low-income customers. That is, until Friday, Aug. 20, when officials from the Federal Deposit Insurance Corporation and the Illinois state government arrived at ShoreBank's headquarters on South Jeffrey Boulevard to seize the bank's assets and take over management. Regulators had determined that ShoreBank was losing too much money to remain solvent and stepped in to protect insured deposits after more than a year of warning the bank it was on the verge of failure. ShoreBank appeared to have collapsed under the weight of its triple-bottom-line mission.

For conservative critics, who saw government policies promoting community development and fair lending as nothing more than market distortions, the collapse was a *fait accompli*. "Social and environmental justice may make for good Volvo bumper stickers," crowed Michelle Malkin. "They do not, however, make for a good bottom line." But those who sympathized with the bank's mission blamed the broader carnage of the recession. "The fact is that ShoreBank was enormously important symbolically, it was very important historically, it was very important to the communities it served," says Cliff Rosenthal, who leads a national federation of community credit unions. "But we've been hit by an economic tsunami in this country." Indeed, the financial crisis has washed away financial institutions of

every stripe -- 307 of them since the beginning of 2008. The FDIC closed seven other banks on the same day it closed ShoreBank.

So which is to blame for the collapse of ShoreBank -- its social-justice mission or the economic downturn? The competing explanations for its failure have made an abstract debate over community finance tangible, with pundits of all stripes citing ShoreBank as an example in recent debates over the government's role in the financial system. The real story, however, is about how we hold banks -- all banks -- accountable.

In 1973, Chicago's South Shore neighborhood was deteriorating. Following the northern migration of African Americans, many to Chicago, the "white flight" of the 1960s had robbed the neighborhood of its economic base. Two out of every 10 storefronts were vacant. "Crime rates, welfare rates, and tax delinquencies had all soared within a relatively short period of time," wrote sociologist Richard Taub in a 1988 study of ShoreBank. The demographic changes -- a shift from 100 percent white in 1960 to 70 percent black just 10 years later -- frightened off investment from conservative bankers, and soon the effects of lending discrimination added to the neighborhood's cycle of decline.

Ronald Grzywinski and Mary Houghton, who worked on minority lending at a different local bank, were unsatisfied with their efforts to make loans to South Shore residents. Inspired by the civil-rights movement, they sought to marry their ideals to their profession. In the early 1970s, the South Shore National Bank was trying to leave the neighborhood, claiming that the economic situation made its survival impossible. Its investors pulled out after regulators denied its application to move, and Grzywinski and Houghton bought the bank for cheap. They spent the first several years managing by the seat of their pants. On day one, the bank was "vastly undercapitalized and overleveraged," according to a history written by Grzywinski in 1991. For a while, the bank employed a guard whose primary job was keeping muggers away from neighborhood residents, and it let a mail-fraud inspector use a desk in the lobby to deter thieves trying to launder money.

Grzywinski and Houghton also faced a number of more prosaic challenges. They needed customers to deposit their savings in a local bank rather than a national chain and investors to put their faith in a neighborhood that didn't promise growth. Economic trends did not bode well for the neighborhood. Retail businesses were struggling to compete with suburban malls, and the number of well-paying, blue-collar jobs was shrinking. After some experimentation, the bank's management found its niche: housing.

ShoreBank created a development affiliate to rehab rotting apartment buildings and loaned local residents -- "black entrepreneurs and Croatian janitors" -- the funds to do the same. Former ShoreBank CEO Anne Arvia says the bank had "a very personal way of lending" based on its knowledge of the neighborhood. Figuring out the market rent means knowing which landlords can effectively manage tenants and what typical renters, often single black mothers, can afford to pay. The bank's attention to detail paid off. By 2008, ShoreBank had \$410 million in multi-family housing-unit loans and nearly \$305 million in home loans on its balance sheet -- almost a third of its assets.

Its investment in the neighborhood led to the end of lending discrimination as other bankers followed ShoreBank's success. Over time, the institution expanded. Under the umbrella of its parent holding company, ShoreBank created a number of socially conscious affiliated nonprofits and a consulting arm and purchased another bank in Washington state. Then it added lending operations in Detroit and

Cleveland. The bank even launched venture-capital funds and support for development loans abroad, including Nobel-winner Mohammed Yunus' Grameen Bank. Those efforts were far from Grzywinski and Houghton's "old-fashioned" original vision of banks based in and devoted to their communities. Few of the 22 other ventures were actually profitable -- they subsisted off the Chicago-based bank.

ShoreBank was involved in politics from the start. In 1976, Grzywinski was famously the only banker to testify on Capitol Hill in favor of the Community Reinvestment Act, a fair-lending law that has been blamed by conservatives for causing the financial crisis by encouraging unsound lending. This myth can be debunked by noting that the act only applies to traditional banks, not the independent mortgage originators and investment banks that produced the bulk of the bad loans at the heart of the foreclosure crisis. Indeed, ShoreBank first rose to national prominence after it survived the Savings & Loan crisis of the early 1990s. The CRA and other legislation championed by ShoreBank and signed into law by Bill Clinton created modern policy around CDFIs, formalizing the business model and spreading it around the country.

By the early 2000s, as Grzywinski, Houghton, and other original founders of the bank entered their late 60s, they focused on other projects under ShoreBank's umbrella and eased themselves out of direct management of the bank they'd worked at for 30 years. Meanwhile, ShoreBank had trouble finding and keeping talented leaders who were committed to its mission. Protracted job searches led to three different CEOs over the course of seven years, including the first outsider to head the institution, a commercial banker who was chauffeured to South Shore from his suburban home. New leadership took advantage of the easy credit atmosphere to expand ShoreBank. At the same time, between 2000 and 2006, the bank's assets doubled to more than \$2 billion. It was an enormous change, and the bank's management responded by planning even more growth, contemplating a public offering and the purchase of another small bank to shore up capital reserves. The real-estate market was booming as investors from Wall Street and suburban house-flippers bought into the bubble. Even as ShoreBank saw its competitors making money on loans that were predatory or unsustainable, none of the bank's leaders seemed to connect the housing bubble with the bad lending going on around them, or with their own institution's expansion.

Still, ShoreBank wasn't engaged in the race to the bottom led by the subprime lenders. Of ShoreBank's loans, only 15 percent were single-home mortgages, and the bank only lent at long-term, fixed rates. Arvia, who led ShoreBank from 2003 to 2006, recalled difficult conversations with longtime customers. They wanted home loans they couldn't afford, and their bankers had to explain why they wouldn't sell them a mortgage even as subprime originators seemed to offer credit with no strings attached. Grzywinski sent Federal Reserve Chair Ben Bernanke a letter in 2007 lobbying for more regulation of subprime lenders, arguing that stronger rules were needed to protect community banks from the unfair competition that attracted their customers with false promises of easy money. As the housing market began to implode that same year, ShoreBank's leaders saw another opportunity to help: They identified 10,000 adjustable-rate mortgages in South Shore with the hope of refinancing as many as possible into sustainable fixed-rate mortgages. The bank made \$32 million in rescue loans just as the financial crisis was beginning. With unemployment rising and subprime loans defaulting, rent became harder to collect and property values dropped. African American unemployment in the city rose to 16 percent.

"When the North Side catches cold, the South Side catches pneumonia," Tim Goodsell, the president of Hyde Park Bank, told me. Hyde Park Bank, where Houghton and Grzywinski worked before beginning ShoreBank, still operates on the South Side. "We have a borrower who is a very reputable property owner, leases buildings to low- and moderate-income people. He's been pounded by delinquencies and

vacancies because of the high level of joblessness," Goodsell adds. ShoreBank had been in the exact same line of business but with far greater exposure. ShoreBank had also concentrated funds in similar projects in Cleveland and Detroit, two other cities decimated when the housing bubble popped. Yet if the bank exists in the toughest places and serves the hardest-hit consumers, doesn't that make failure in a crisis inevitable?

Not necessarily. Few banks -- not just community-based lenders -- prepared themselves for the possibility of a national downturn as severe as the one we've encountered. It's somewhat ironic that ShoreBank's hyper-local underwriting formula was affected by the mass-market loan and securities generation of Wall Street -- which, incidentally, wouldn't have survived itself without massive government aid. Other lenders based on ShoreBank's model, including Southern Bancorp, a bank in Arkansas that Grzywinski launched at the request of then-Gov. Bill Clinton, remain solvent.

The question remains: What was different in Chicago?

ShoreBank recorded a loss of \$2.4 million in the first quarter of 2009. Soon, losses began outpacing the bank's reserves, and by midsummer, regulators had sent the bank a cease-and-desist letter ordering it to raise more capital. By the end of 2009, the bank had lost \$100 million -- well over half the equity capital it reported at the beginning of the year. Executives scrambled to bolster the bank's finances, bringing in new board members to help raise money. Their goal was to gather enough private capital to satisfy the regulators and gain access to money from the Troubled Asset Relief Program (TARP), the bank-bailout fund that had allowed large Wall Street banks, which many observers suspect were insolvent, to recapitalize themselves. Bank executives cajoled investors, ranging from the Ford and MacArthur Foundations to major Wall Street banks like Goldman Sachs and Bank of America -- which get benefits for investing in CDFIs -- into providing the funding over several months.

Immediately, the deal became politicized. Critics saw ShoreBank, based in President Obama's home neighborhood, as a "favored" institution -- the president had known some of the founders and had served on other boards with them. Bill and Hillary Clinton had long been close with the bank's founders, with Bill even incorporating a plan to found 100 ShoreBanks across the country into his 1992 campaign platform. He called up Illinois regulators on the bank's behalf, citing his foundation's interest in development. Local politicians, including Illinois Rep. Jan Schakowsky and Sen. Dick Durbin, also asked regulators to support the local bank, on which their constituents depended.

Yet there's no evidence that the bank received favorable treatment from regulators or investors or that anyone in the Obama administration was connected with the bank's failure. While it's possible that investment officers at the major banks expected some political favor in return for their planned investment, the bailout plan never went through -- by the time the bank assembled the initial tranches of private investment, its balance sheet had so deteriorated that the Treasury Department refused to hand over the \$75 million in TARP funding it had originally made available.

With that decision, the last hope of a rescue disappeared. The regulators showed up on a Friday evening in August, ShoreBank's management was fired, and its shareholders were wiped out.

Even though the institution didn't survive, its mission may. David Vitale, a Chicago banker who has devoted his later years to turning around local institutions in need -- from the Chicago Board of Trade to

the city's school system -- joined ShoreBank's board a few months before the end to help with the capital-raising effort. When it failed, he pulled together a consortium of investors, mainly foundations and financial institutions who had previously invested in ShoreBank, to obtain a new charter and funds to purchase the bank from the FDIC upon its seizure. It is now operating as Urban Partnership Bank.

A new conservative conspiracy theory arose: Regulators were letting the FDIC's insurance fund absorb losses so that the social experiment could start anew. This theory doesn't hold up under scrutiny, either. While the FDIC's fund will take a \$367.7 million hit under the agreement, had a new group of investors not stepped forward -- after the FDIC gave several hundred banks the opportunity to bid on ShoreBank's remains -- the government would be on the hook for all of the losses. Had it sold ShoreBank to another bank, the FDIC would have had to offer a steep discount. As it is, Urban Partnership Bank and the FDIC will share further losses on some \$1.4 billion of ShoreBank's remaining assets. Rumors that the bank's management team continued were unfounded; the only holdovers are Vitale and his team, who joined the bank just before its failure. Most of the new bank's management is from the former First Chicago Bank, which Vitale once led.

Urban Partnership looks likely to maintain ShoreBank's philosophy and status as a CDFI, though the bank's operations are still in transition. The institution reported a small profit in its first quarter, and is eschewing Shorebank's diverse commitments to refocus on its Chicago operations. It still won't begin lending for at least six months. It still won't begin lending for at least six months.

Bankers in Chicago and elsewhere believe ShoreBank's failure was less because of its mission and more because of its business practices. The bank tried to accomplish too much, too fast, making expansion a priority above executive salaries (which stayed low compared to industry averages) and, critically, maintaining enough reserves. It was a single local bank supporting nearly two dozen affiliates that did everything from invest in Afghanistan to make home loans in Detroit. Ultimately, ShoreBank's excesses were very similar to those of banks with only one bottom line: imprudent addition of business lines that weren't well understood, rapid expansion without controlling for risk, and a lack of capital reserves for when times got tough. None of those practices are intrinsic to CDFIs; indeed, if those are the crimes for which critics indict CDFIs, then the entire financial system is guilty.

"[ShoreBank] went through, from 1973 on, some very serious downturns and survived," says Arvia, the former CEO, who now works at Nationwide Insurance. "[But] the mission's interest expanded well beyond the South Side of Chicago, and that's what I would call the biggest mistake. In good times, when the bank was growing rapidly, the ability to retain that profit ... was not allowed to happen because it was funding the shiny new toy. That's my biggest regret, that I didn't push harder to protect the bank from that kind of expansion. It's hard for a bank of any kind to support that kind of cost structure."

Despite ideological arguments over the bank's model, Grzywinski's theory of banking is not dissimilar from that of Amar Bhide, the Tufts University finance professor who offers a critique of banking inspired by conservative economist Friedrich Hayek: Lending has to be a human occupation, not mechanized, and based locally, because centralization eliminates a loan officer's judgment -- exactly the kind of judgment ShoreBank used to profit initially. When it lost focus on that mission and spread its resources too thin, disaster struck, just as it did nationally.

Yet ShoreBank's experience is being taken as a call to end government support for community lenders, as though encouraging credit access in underserved communities is the moral equivalent of bailing out Wall Street's megabanks. "At times it seems like no one has learned anything from the financial crisis,"

concludes a story in National Review. "The ShoreBank example sends a clear message that if you play ball with the Democrats' political agenda, Obama and his friends can get you all the capital you need." But this isn't a partisan issue -- 165 Republicans voted for the original CDFI legislation.

Setting aside ShoreBank's status as a political football, its experience is emblematic of the challenges facing many local banks after the financial crisis. The large banks that catalyzed the recession have survived and even expanded thanks to claims of systemic importance, government intervention, and regulators looking the other way. The small banks that got caught up in boom and bust without issuing predatory loans have been left in tatters. When community banks -- whose customers have both the most need for fair access and are hardest hit by the recession -- sought TARP funding, they were subject to restrictions intended for the largest banks. Experts estimate that more than 100 other small banks will fail before the crisis ends, and little is being done to bolster their chances of survival.

Of course, creative destruction is part of capitalism. But the communities that relied on ShoreBank will be hard-pressed to find sustainable investors if Urban Partnership does not succeed. The stakes are high, and not only for residents of Chicago's South Side.

Location is still everything. The community that once inspired Grzywinski and Houghton to found ShoreBank is in trouble again today. The recession has left it economically scarred, with higher-than-average unemployment and a crushed housing market. It's unclear whether development money will be available to help rebuild, and the politicization of ShoreBank's failure distracts from the urgent need to reinvest in these areas with sustainable, local loans. ShoreBank may teach some important lessons about this financial crisis -- about size, interconnectedness, and the financial corruption of political elites -- but these lessons have little bearing on the community banks that played by the rules and lost.

"To serve almost any geographical or social community we might name, banks must either be small or at the very least maintain a local focus," Grzywinski wrote in 1991, adding that "the best way to achieve a community development agenda is with the hard discipline of a business." As other businesses lost their discipline, borrowing too much too cheaply, the bank Grzywinski created did the same and in the process, lost its focus on South Shore.

But ShoreBank's broader accomplishment remains. The idea that location should determine the availability of credit -- a thinly veiled way to say that the color of your skin or the area where you grew up should affect your ability to get a loan -- made economic development in struggling neighborhoods rare. ShoreBank proved that by priming the pump with credit, it was possible to create growth in poor neighborhoods and attract other lenders to do the same -- sometimes with unintended consequences.

Rebuilding in Chicago -- and around the country -- will require policies that encourage community banks to do what they do best and avoid the excesses that plagued the financial sector. With poverty now at its highest level in 50 years, this is no time for responsible bankers to give up. "My sense from driving around is that in places where there had been lots of signs of hope, there are fewer," says Taub, the Chicago sociologist who has watched ShoreBank for decades. "All the fucking biggest banks in the United States with the smartest brains working for them went broke. Why should anyone think ShoreBank is different or better than them?"

Correction: This story previously reported that Urban Partnership Bank had sold a bank in Washington state. However, that bank was sold by Shorebank's parent holding company and was never owned by Urban Partnership Bank, which only purchased Shorebank itself from the FDIC after the regulator placed the failing institution into receivership.