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Special Edition for the World Economic Forum Annual Meeting 2009

Social Innovation in a Post-Crisis World

FEATURING SCHWAB SOCIAL ENTREPRENEURS

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About *Innovations*

***Innovations* is about entrepreneurial solutions to global challenges.**

The journal features cases authored by exceptional innovators; commentary and research from leading academics; and essays from globally recognized executives and political leaders. The journal is jointly hosted at George Mason University's School of Public Policy, Harvard's Kennedy School of Government, and MIT's Legatum Center for Development and Entrepreneurship.

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Ellen Seidman and Ron Grzywinski

A Bank as Courageous Investor

ShoreBank is an American bank born during an earlier housing crisis. The 1960s were a period of intense racial turmoil in the United States, especially in northern cities. Chicago was no exception. Between 1960 and 1970, Chicago's South Shore neighborhood—full of lovely apartment buildings and solid single-family houses, bordering both Lake Michigan and the city's famed park system—changed from nearly all white to nearly all African-American. House prices plunged, businesses fled, and credit was virtually unavailable. And in 1972, the community's last bank, South Shore National Bank, announced it was moving downtown after losing half of its deposits and shrinking to $40 million.

In 1973, Ron Grzywinski (one of the co-authors of this essay), Mary Houghton, and two now-deceased partners, were running a small business loan unit for African-American borrowers at Hyde Park Bank in the university neighborhood just north of South Shore. Their positive small business lending experience convinced the group that providing full, respectful banking services to communities like South Shore could both stabilize the community and release the entrepreneurial energy of those who now called it home. Putting their reputations on the line, and using $800,000 in equity from ten socially oriented investors, the four founders bought South Shore National Bank.

The group chose a commercial bank as the vehicle for social investment and community change for two complementary reasons. First, banking services would be both sustaining and sustainable for the community in the long term. Second, they reasoned that if they used a standard, well-known, highly regulated corporate structure, their success would demonstrate to an audience far beyond Chicago that providing banking services to communities like South Shore was more than a feel-good proposition—it was commercially viable. At the same time, investors recognized the importance of patient capital that expected most of the bank's profits to be reinvested in the community rather than distributed and that did not expect a bonanza by selling out.

Ronald Grzywinski is Chairman/CEO of ShoreBank Corporation. He was selected by the Schwab Foundation for Social Entrepreneurship as an Outstanding Social Entrepreneur in 2007.

Ellen Seidman is Executive Vice President of ShoreBank Corporation and was the chief regulator of the Office of Thrift Supervision during the Clinton Administration.

Fortuitously, the Federal Reserve Board of Governors had identified community development as a permissible activity of bank holding companies in 1970. This let ShoreBank Corporation strategically complement the services provided by the core commercial bank. The holding company structure has in the past included a nonprofit job-training organization and a for-profit real estate development company. It now includes not only another commercial bank (in the Pacific Northwest, focused on environmental sustainability) but also four nonprofit loan funds, a for-profit international consulting company, an international equity investment management company, and two cutting-edge nonprofits that help guide commercial bankers in the United States and the developing world to better serve people and communities like those ShoreBank itself serves.

> ShoreBank has always done in-depth underwriting, a critical element of sustainable homeownership. The bank doesn't rely on credit scores. Instead it asks: What is the customer's income, and how steady is it? How much are they paying on their mortgage? What do insurance and property taxes cost? What are their other debts? How many people are they supporting?

ShoreBank's first two decades were characterized by experimentation, failures as well as successes, and slow growth. In the early 1990s, the large banks in Chicago became investors, recognizing that an investment in a specialized urban bank would help them meet their obligations under the Community Reinvestment Act, federal legislation requiring insured depositories to serve low-income geographies within their market areas. By 1995, the bank board recognized that the bank's long-term success, as well as its ability to continue to experiment and diversify, required a much larger asset base. The bank doubled its size by purchasing another community bank that served Chicago neighborhoods near and like South Shore. At the request of, and with the capital support of, leaders in Cleveland and Detroit, the holding company also expanded into similar neighborhoods in those cities.

The strategy was successful, and over the next decade, ShoreBank was able to prosper, grow, and continue experimenting. Its signature product is support for entrepreneurs, almost entirely either African-American or immigrant, who buy and rehabilitate small apartment buildings. Its success is due to its deep local market knowledge and skilled relationship banking. Borrowers complete high-quality rehabilitation of apartments that rent at affordable prices.

ShoreBank also began to do more single-family lending. Our philosophy has much in common with all quality community banks: know and care about your customer, because both of you have a strong interest in the customer's success in repaying the first loan, growing net worth, and becoming more successful. We believe that customers deserve a complete look at their finances to determine whether they can afford the loan they need to buy the property they are interested in. ShoreBank makes only long-term, self-amortizing, fixed-rate mortgage loans, and it makes them to responsible investor-owners as well as to owner-occupants because there is substantial demand for quality, affordable rental housing. The result: a charge-off rate on owner-occupied houses even today of only 15 basis points, compared to the average for our peers of 32 basis points.

As the current decade unfolded, the bank's lenders began to notice some troubling signs. Homeowners and buyers were being inundated by primarily non-local, non-bank lenders offering single-family mortgage products that would have been unsafe for anyone, but especially for borrowers with tight balance sheets and modest incomes. ShoreBank could not compete with those offering "no down payment, low monthly payment" loans whose payment would increase dramatically six months to three years after the loan was originated, and depended for repayment on being able to refinance. We stayed in the market and had some success, but became concerned about the damage being done to our communities as house prices climbed to unsustainable levels, supported by mortgages that were also unsustainable.

By 2007, foreclosures in Chicago had started to increase dramatically; as bankers who cared deeply about our communities, we knew that more drastic measures were needed. In September 2007, we launched the Rescue and Prevention Loan Program with the goal of reaching at least 1,000 of the more than 10,000 families in our communities who had mortgages they would not be able to afford when their payments increased. We wanted to find them before they got into trouble, and to refinance as many as possible into quality long-term mortgages they could afford, consistent with the safety and soundness standards of a commercial bank.

The Rescue and Prevention Loan Program has five critical elements: outreach, in-depth underwriting, loans that sustain homeownership over the long term, counseling, and funding. Through August 31, 2008, we have made 137 loans under the program, for a total of almost $25 million. We are able to refinance almost 70% of those who apply.

Finding borrowers who need and can benefit from our program is not easy. Many borrowers who have "exploding" adjustable rate mortgages or mortgages that don't include an escrow for property taxes don't realize the trouble they could be in until after it happens. And borrowers in our communities, as in communities around the country, are both proud and scared; the combination makes them reluctant to reach out until they are desperate, and by then it is far more difficult to help them. So we assembled a well-trained, community-sensitive marketing team. That team has done 40 formal outreach seminars and meetings since the program started, but they also operate informally: the head of mortgage lending now goes to church several times on Sunday to make sure the community knows what we have to offer.

ShoreBank has always done in-depth underwriting, a critical element of sustainable homeownership. The bank doesn't rely on credit scores. Instead it asks: What is the customer's income, and how steady is it? How much are they paying on their mortgage? What do insurance and property taxes cost? What are their other debts? How many people are they supporting? In the Rescue and Prevention Loan Program, the bank pushes its underwriting standards a little further than usual in terms of traditional debt-to-income and loan-to-value ratios.

Rescue Loans are funded largely through a high-yield savings account, an online savings account that pays depositors a market rate of interest (currently 3.5%) and attracts both new and existing account holders who are interested in supporting our social mission. The bank has raised more than $27 million in deposits through this mechanism, and deposits have held stable since the bank lowered the interest rate from an initial premium rate. A low interest rate $15 million deposit from the MacArthur Foundation will cover some of the bank's loan losses and provide funds for low-interest-rate, deferred-payment second mortgages. The support from MacArthur is particularly welcome, as the current crisis has resulted in an increase in ShoreBank's charge-off rate on all 1- to 4-unit properties (both owner-occupied and rental) from a historically low 16 basis points annually to 86 basis points today.

ShoreBank's response to the current mortgage and housing crisis represents the same spirit that gave birth to ShoreBank: a strong belief by the bank and by socially-interested investors across the country that lower-income neighborhoods and the people in them can thrive. What they need is a combination of patient capital, financial discipline, and entrepreneurial creativity. In ShoreBank's case, acting on that belief has resulted in 34 consecutive years of profitable operations, growth to $2.6 billion in total assets, current capacity to advance about $450 million annually in new community development and/or environmental loans, and participation in a growing global network of social enterprise.

* * * *

So far we have discussed why and how ShoreBank has stepped up in its communities in response to the ongoing U.S. mortgage crisis. ShoreBank is one of approximately 50 certified Community Development Financial Institution banks; there are about 150 certified credit unions, and 600 non-profit loan funds. The CDFIs have a primary purpose of service to low- and moderate-income communities. They are tied closely to these communities not only through their loans, but also because their boards and employees are members of the communities. They are small institutions and almost always hold—and thus retain the risk of—the loans they make, rather than selling them into the capital markets. This gives them both the insight to understand what is happening in the neighborhoods, and the incentive to help their customers succeed—and to work with them quickly when they run into problems.

More far-flung organizations and those that do not serve lower-income neighborhoods did not have either this knowledge or—having apparently disposed of the risk of default—the incentive to help fix the problems that were frequently of their own creation. The result was that they encouraged and facilitated the development and exponential growth of the "originate to sell" model of mortgage financing. Under this model, mortgage brokers sold unsuitable, often predatory, mortgage loans funded through the capital markets rather than by deposits that depended for repayment on constantly increasing house prices.

Some have blamed the mortgage debacle on the Community Reinvestment Act's (CRA) requirement that banks serve low- and moderate-income communities. Federal bank regulators have all firmly stated that CRA was not responsible for the sub-prime debacle or its broader implications. While lower-income and minority communities were disproportionately the victims of predatory financing, these loans were widespread. The vast majority were made to borrowers and in communities that were never the focus of CRA, and they were mostly made by independent mortgage bankers who are not subject to CRA.

ShoreBank is by far the largest of the CDFI institutions, and while several others hold and/or manage assets of more than $500 million, the industry as a whole has under $20 billion under management. Looking more broadly, the 7,700 banks and thrifts in the United States with under $1 billion in assets—the standard, though by no means perfect, definition of a community bank—have $1.5 trillion in assets. In contrast, home mortgages outstanding in the United States totaled approximately $10 trillion. Of these, approximately $900 billion were sub-prime mortgages, the sector most in crisis. While ShoreBank and other mission- and community-oriented institutions can help individual families and businesses in their communities, the crisis truly exceeds their capacity.

The larger lending organizations, which originated, packaged, sold and now service the loans most at issue, must step up, as must the government, in a manner different from what they have done to date. While house prices had clearly been inflated far beyond intrinsic values, and needed to decline, governments at all levels and lenders must step in to dampen the dangerous downward spiral in which foreclosures depress property values which in turn generate further foreclosures, especially as the economy has fallen into recession. Lenders and servicers must modify loans to standards of affordability. Governments must work with lenders, developers, and community organizations to keep properties occupied even if the loan defaults and to quickly put vacant properties back into service or—in overbuilt or depopulating areas—to demolish them. And we must all take advantage of this situation to rebuild financially strong and environmentally healthy communities for all Americans.

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editors@innovationsjournal.net