REINVESTMENT ALERT

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Doing Well While Doing Good: The Growth of Community Development Banking, 1992-2001

Introduction[1]

Access to capital and credit is a vital component of an economically healthy community. The absence of fairly priced capital and credit for housing, small businesses, shops, and individual household goods result in the breakdown of the local economy. Traditionally, community banks have served local community financial needs, particularly the demand for those products that are satisfied through relationship finance – finance that is facilitated by personal interaction between banks, small borrowers, and small depositors. But the number of small community banks (community banks with assets of less than $100 million) has fallen from around 11,000 in 1980 to 5,000 today.[2] Large banks have not taken up the slack. Moreover, high cost, high fee predatory mortgage and consumer lenders have targeted vulnerable neighborhoods with products that strip assets from and impoverish local residents.[3]

Large banks use a transaction-based approach to lending, using credit scoring and on-line applications for small business, mortgage, and credit card borrowers. They manage risk through pooling and securitizing some of their loans, relying on standardization of products across different kinds of markets. But in lower-income markets, a large number of customers and deals may be "not quite bankable" for standard products, and some immigrant groups bring with them a suspicion of financial service corporations and will not respond to the transaction-based mentality. Who then will serve these markets? Regular financial institutions, larger community banks and large banks, as they get more creative at serving these communities, must provide a major part of the answer. But since the early 1970s, the cutting edge of banking in underserved markets has been the community development bank, a concept pioneered by South Shore Bank starting in 1973.

This Alert describes the expansion of the community development banking industry over the past ten years. While only a handful of community development banks existed 20 years ago, there are nearly 40 in existence today. Community development banks are comprehensive financial institutions serving economically distressed communities. While regulated in the same way as traditional financial institutions, a community development bank goes beyond the traditional bank's mission of providing credit and financial services – its primary mission is to positively impact community economic

[1]The authors would like to thank Dan Immergluck of Grand Valley State University, Raymond Rusnak of LaSalle Bank, Thomas Fitzgibbon of MB Financial Bank, George Surgeon of Shorebank Corporation, Lisa Richter of the National Community Investment Fund (NCIF), and Sean Zielenbach of Housing Research Foundation for help in preparation of this Alert.

[2]See Robert DeYoung, William C Hunter, and Gregory F. Udell for the argument that such relationships create information efficiencies in "Wither the Community Bank? Relationship Finance in the Information Age," Chicago Fed Letter, June 2002, #178.

[3]Immergluck and Wiles, 1999. Woodstock Institute Reinvestment Alert, #14.

development and spur renewal in targeted communities. This Alert shows how community development banks have grown in size and financial strength while at the same time serving their community development mission.

Methodology

For the purpose of this alert, community development banks are those banks that are certified as being a Community Development Financial Institution (CDFI) by the Community Development Financial Institutions (CDFI) Fund.[4] CDFI certification signifies that a financial institution meets the six criteria set forth by the CDFI Fund. The institution must:[5]

- Have a primary mission of promoting community development;
- Be a financing entity;
- Serve a target market;
- Provide development services together with its financing services;
- Be accountable to its target market; and
- Be a non-governmental activity.

This report looks at the growth and stability of community development banks using data on key indicators obtained from the Federal Deposit Insurance Corporation (FDIC). Bank data was gathered for the past ten year period, using 1992, 1996, and 2001 as benchmarks. The year 1992 is the first year for which data are readily available for individual banks. The year 1996 is the first year in which CDFI Fund awards were granted. Finally, 2001 is the most recent year for which data are available.

This report focuses on the community development banks with CDFI certification as of December 31, 2001. Information for 1992 and 1996 reflects the number of community development banks in existence and CDFI certified in 2001 that were also in existence in 1992 and 1996. No bank was CDFI certified in 1992, as the CDFI Fund was not created until the passage of the Riegle Community Development and Regulatory Improvement Act of 1994, with operations beginning in fiscal year 1995.[6] Information regarding the number of banks with CDFI certification in 1996 is unavailable.

Scope of the Community Development Banking Industry

The community development banking industry has grown steadily since 1992. As of December 31, 2001, there were 39 CDFI certified community development banks. Of these 39 banks, 27 were also in existence in 1992. Thirty-two of these banks were in existence in 1996 (Figure 1). Employment in the industry has grown as well, increasing from 1,230 employees (full-time equivalent) in 1992, to 2,203 employees in 2001, an increase of approximately 79 percent (Figure 2).

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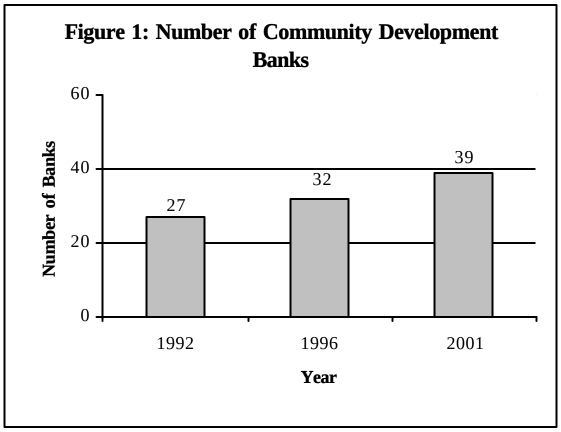
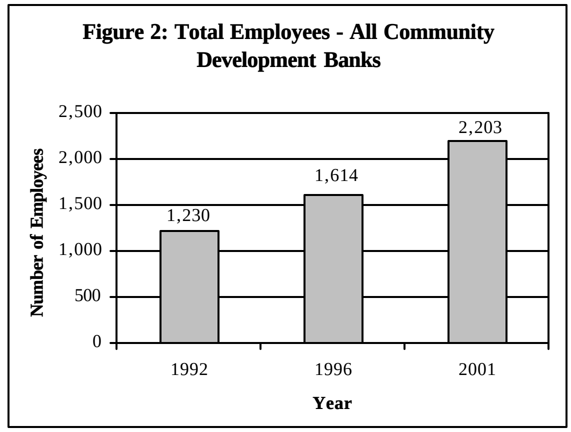
[4]The CDFI Fund was authorized by the Riegle Community Development and Regulatory Improvement Act of 1994. The purpose of the Fund is to expand the availability of credit, investment capital, and financial services in distressed urban and rural communities. The Fund provides relatively small infusions of capital to institutions that serve distressed communities and low-income individuals. The Fund's activities leverage private-sector investments from banks, foundations, and other funding sources. Since the Fund's creation, it has made more than $534 million in awards to community development organizations and financial institutions. See CDFI Fund website, http://www.cdfifund.gov.

[5]CDFI Fund.

[6]CDFI Fund, 1997.

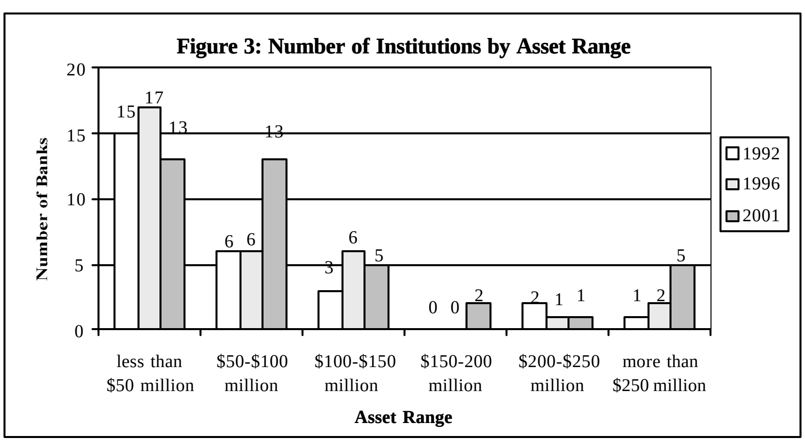




Growth in the community development industry is the result of the creation of de novo banks or by the conversion of existing banks into community development banks. The increase in the number of community development banks between 1992 and 2001 reflects both strategies. A large number of conversions have been of minority-owned banks. Many of the conversions of existing banks into community development banks, both minority-owned and non-minority owned, were assisted by the National Community Investment Fund (NCIF), an independent trust and certified CDFI intermediary that reinvests institutional capital in independent and minority-owned financial institutions with a community development focus.[7]

Assets

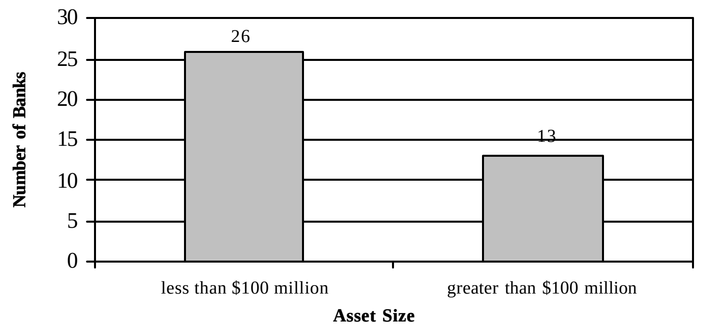
Community development banks are predominately small institutions that have assets of less than $100 million (Figure 3). In 1992 and in 1996, more than half of all community development banks had assets totaling less than $50 million. While community development banks remain predominately small in asset size, as the industry matures more banks are moving into the larger asset size categories. The number of banks in the $50 - $100 million asset range more than doubled between 1996 and 2001. Most notable is the growth in the $250 million and above category, from one bank in 1992 to five banks in 2001.



[7]For more information, please visit the NCIF website at http://www.ncif.org.

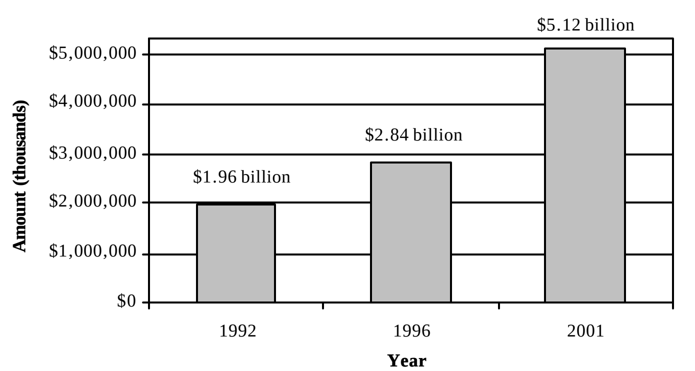
But the majority of community development banks are small banks, with assets less than $100 million. In 2001, two-thirds of community development banks had assets less than $100 million, with just one-third of banks holding assets greater than $100 million (Figure 4). Age of the bank plays an important role in this regard. All of the community development banks established after 1996 had assets less than $80 million.

Figure 4: Community Development Banks by Asset Size, 2001



The cumulative total asset size of all community development banks demonstrates strong growth in the size of the industry throughout the study period (Figure 5). In 1992, the cumulative asset size of all community development banks totaled approximately $1.96 billion. By 1996, this figure rose nearly 45 percent, to $2.84 billion. Between 1996 and 2001, this figure rose again, to $5.12 billion, an increase of 80 percent. Overall, the cumulative total assets of all community development banks increased 161 percent between 1992 and 2001.

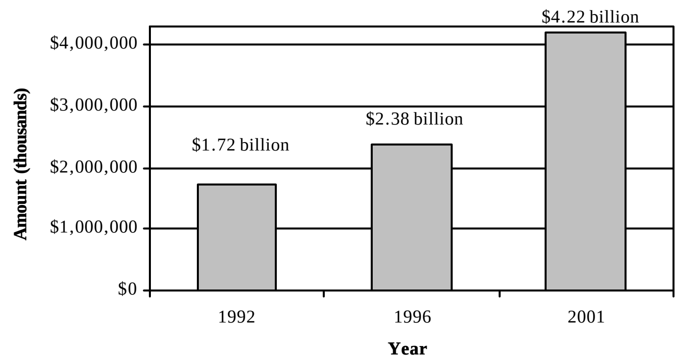
Figure 5: Total Assets of Community Development Banks



Deposits

Community development bank deposits have been growing throughout the past ten years (Figure 6). Total deposits grew from approximately $1.72 billion in 1992 to $2.38 billion in 1996, an increase of

Figure 6: Total Deposits of Community Development Banks

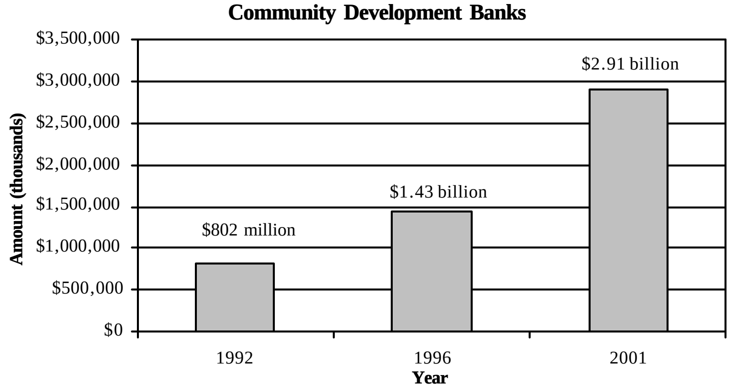


38 percent. Deposit growth was even stronger between 1996 and 2001, reaching $4.22 billion, an increase of nearly 77 percent.

Lending

Lending has increased steadily between 1992 and 2001 (Figure 7). Community development bank lending increased by 78 percent, from approximately $802 million to $1.43 billion between 1992 and 1996. Between 1996 and 2001, lending activity increased by 104 percent, from approximately $1.43 billion to $2.91 billion. Overall, lending volume increased 263 percent between 1992 and 2001.

Figure 7: Gross Loans & Leases of Community Development Banks



Special Considerations in Assessing the Performance of Community Development Banks

A community development bank is chartered and regulated in exactly the same way as a conventional commercial financial institution. As such, it must adhere to the same safety and soundness standards as a traditional bank. However, a community development bank faces a dual standard of performance – a so-called double bottom line: not only is it evaluated by soundness and profitability measures, it is also judged by how well it serves lower-income customers and its community development impact in lower-income communities.

While community development banks must make a profit in order to stay in business, they are not simply profit maximizing institutions. Community development banks deliberately seek out markets that have been neglected by traditional financial institutions that may perceive such markets or borrowers as entailing higher risks or lower returns.[8]

Finally, the community development banking industry is young and growing. Nearly one-third of all community development banks were established after 1992. Like any start-up business, de novo banks face many challenges. However, de novo community development banks face additional challenges such as limited capital supplies, finding patient investors, learning how to develop profitable loan products that serve the needs of underbanked, unconventional customers, or recruiting qualified executives and board members who are committed to the community development mission.[9]

The following section focuses on the financial performance of community development banks by means of capital adequacy and profitability measures. It is important to keep in mind the dual standard of financial sustainability and community development impact and the special challenges faced by this young and expanding industry when evaluating community development banks by conventional performance measures.

Leverage and Capital Adequacy Measures

Core Capital (Leverage) Ratio

The core capital (leverage) ratio is a measure of a bank's capital adequacy. The ratio represents tier-1 (core) capital as a percent of average total assets.[10] A bank that is adequately capitalized will have a core capital ratio no lower than 4 percent. A core capital ratio below 4 percent does not have adequate financial resources.[11] A bank that cannot meet the minimum requirement is capable of sustaining a lower amount of net losses before becoming insolvent.[12] However, 4 percent is the minimum threshold a bank must meet to avoid regulatory action. In practice, a bank's goal is to be well capitalized, having a core capital ratio of 5 percent or higher.

Median core capital ratios indicate that community development banks are well capitalized (Figure 8). The median core capital (leverage) ratio for all community development banks was 6.85 percent in 1992, rising to 8.07 percent in 1996. The median ratio declined slightly to 8 percent in 2001, but remains well above the well-capitalized threshold of 5 percent.

[8]Tholin, 1995.

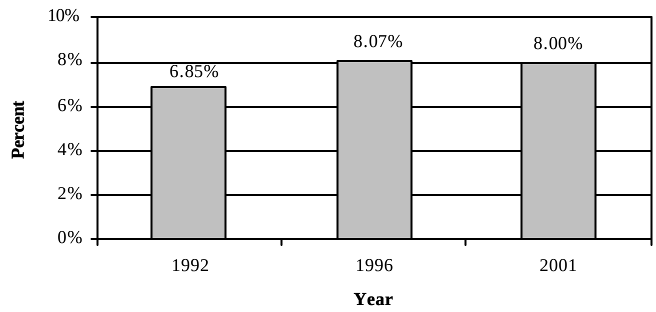
9Surgeon, 2002.

[10]Core or tier-1 capital consists of common stakeholders' equity, noncumulative preferred stock, and minority interest in the equity of consolidated subsidiaries less goodwill. Goodwill is an intangible asset which represents the amount in excess of book value paid by one firm to acquire another. See Sinkey, 1992.

[11]FDIC, 2000.

[12]Mercer, 1992.

Figure 8: Median Core Capital (leverage) Ratio of Community Development Banks



Total Risk Based Capital

Risk-based capital standards are another factor in determining a bank's capital adequacy. Risk-based capital ratios measure assets based upon their perceived credit risk. There are two types of risk-based ratios, the total risk-based capital ratio and the tier-1 risked based capital ratio.

The total risk-based capital ratio shows total risk based capital as a percent of risk-weighted assets. The tier-1 risk based capital ratio shows tier-1 (core) capital as a percent of risk-weighted assets.[13] An adequately capitalized bank will maintain a risk-based capital ratio of 8 percent, with 4 percent of this in the form of tier-1 (core) capital.[14] A well-capitalized bank will maintain a risk-based capital ratio of 10 percent, with 6 percent in the form of tier-1 (core) capital.

Median total risk-based capital and tier-1 risk based capital measures of community development banks met the well-capitalized standard for each of the three benchmark years. (Figures 9 and 10). It is important to note that as the community developing banking industry matures, both ratios have been decreasing, indicating that lending as a proportion of capital is increasing over time.

Figure 9: Median Total Risk Based Capital of Community Development Banks

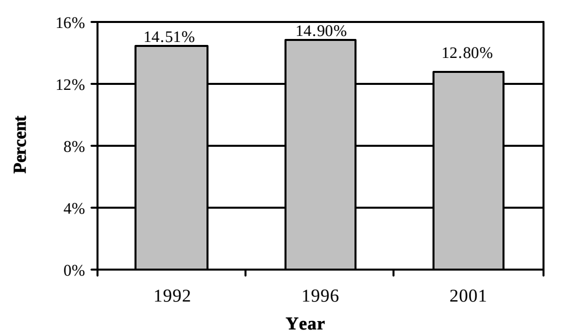
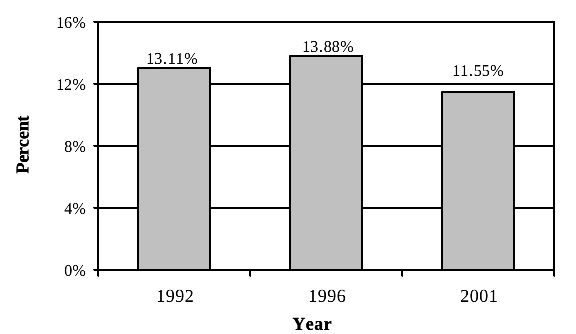


Figure 10: Median Tier-1 Risk Based Capital of Community Development Banks

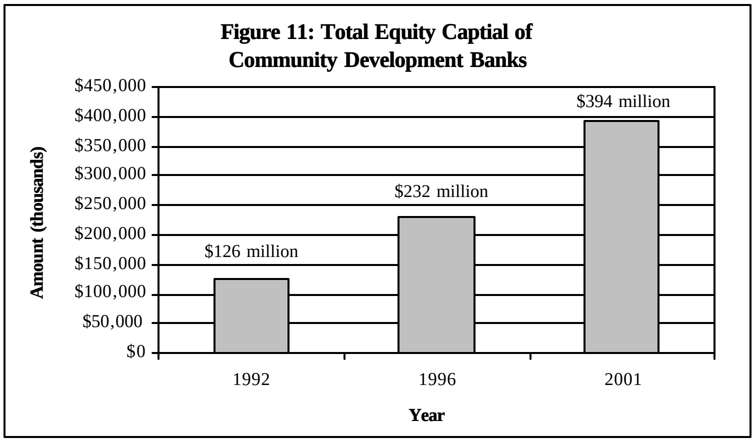


[13]FDIC Institution Directory.

[14]Sinkey, 1992.

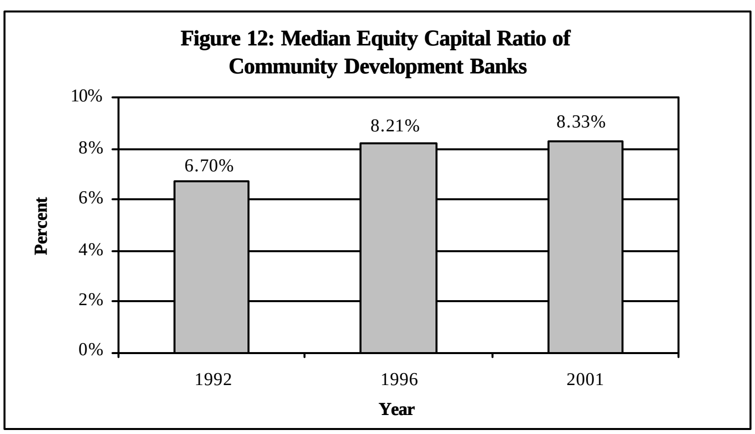
Growth in Equity Capital

Equity capital functions as a cushion to absorb a bank's losses. Figure 11 shows the sum of equity capital for all community development banks for each of the three benchmark years. Total community development bank equity has grown substantially since 1992 (Figure 11). Between 1992 and 1996, total equity increased 83 percent, from approximately $126 million to $232 million. Total equity increased another 70 percent between 1996 and 2001, from $232 million to $394 million.



Equity Capital Ratio

The equity capital ratio shows total equity capital as a percent of total assets.[15] This ratio is a measure of a bank's financial strength. The higher the capital ratio, the safer or financially stronger the bank. An equity capital ratio in the range of 7-9 percent is typical of similar sized banks.[16] The median equity capital ratio of community development banks has been within this range throughout the study period (Figure 12).



[15]FDIC Institution Directory.

[16]Sinkey, 1992.

Profitability Measures

Return on Assets (ROA)

Return on Assets (ROA) is a measure of bank performance. ROA shows a bank's profit per dollar of assets, or how profitably a bank's assets are employed.[17] The ratio is derived by dividing net income by average total assets. The higher the ROA, the more profitable the bank is. Regardless of size, a bank with a ROA of one percent or better is considered to be performing well.[18]

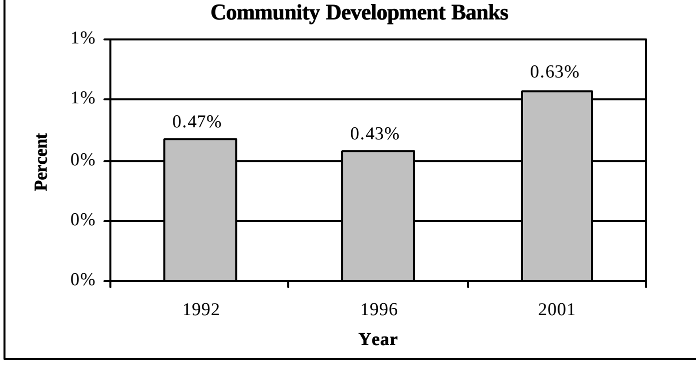
Community development banks have been somewhat below the one-percent threshold throughout the study period (Figure 13). Median ROA declined slightly between 1992 to 1996, from 0.47 percent to 0.43 percent. This decline can be linked to the emergence of new community development banks. By 2001, the average ROA rose to 0.63 percent, surpassing the 1992 level. Seven new banks emerged after 1997, suggesting that community development banks are becoming more profitable as the industry matures. At the same time, the number of community development banks is expanding.

It is important to note that community development banks are not simply profit maximizing institutions. They deliberately seek out customers whose business may entail higher transaction costs and deals that are judged by community development impact as well as profitability. Rising median ROA indicates that community development banks are becoming increasingly profitable while at the same time fulfilling their mission of serving lower-income communities.

Return on Equity (ROE)

Return on equity (ROE) is another measure of bank profitability. It differs from ROA in that ROE measures bank profits per dollar of equity, rather than profits per dollar of assets. ROE is a measure of profitability from the shareholder's perspective.[19] The ROE for a community bank typically ranges from 13 to 16 percent.

Figure 13: Median Return on Assets of Community Development Banks



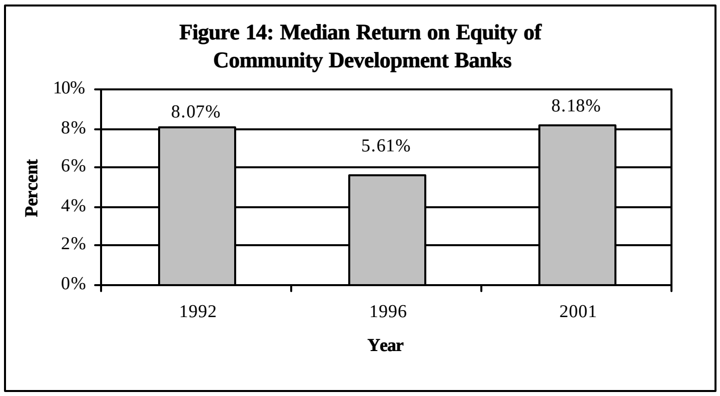
[17] Sinkey, 1992.

[18] Ibid.

[19] Sinkey, 1992.

Community development banks had a median ROE of 8.07 percent in 1992 (Figure 14). The median dropped to 5.61 percent in 1996, but increased to 8.18 percent in 2001. The below average ROE performance, particularly the sharp decline between 1992 and 1996, can be attributed to the expansion of the community development banking industry and the emergence of new banks.

It is important to note the rebound in ROE between 1996 and 2001. Similarly, as we saw previously, risk-based capital standards are decreasing as well, indicating that on average, community development banks are becoming more profitable as the industry matures while continuing to expand.



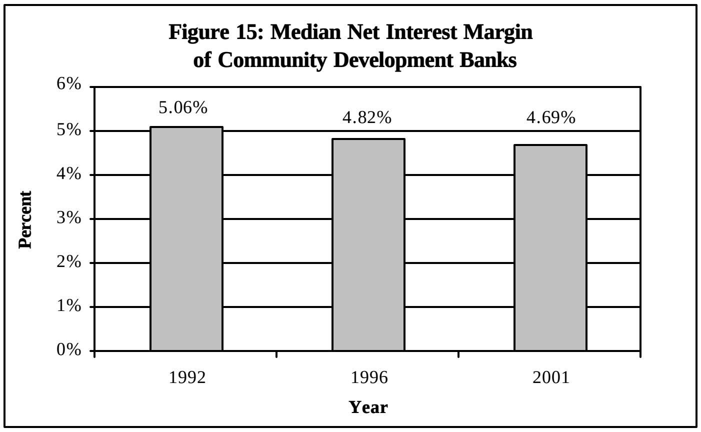
Net Interest Margin

Net interest margin is another way to determine a bank's profitability. It is a measure of a bank's ability to cover costs such as loan losses, taxes, and dividends.[20] Net interest margin is a ratio showing net interest income as a percentage of average assets.[21] Between 1992 and 2001, the net interest margin of all banks with assets of less than $1 billion (all but one community development bank has assets greater than $1 billion) was between 4.5 percent and 5 percent.[22] The average net interest margin achieved by community development banks is within this range, at 5.06 percent in 1992, 4.82 percent in 1996, and 4.69 percent in 2001 (Figure 15).

[20]Sinkey, 1992.

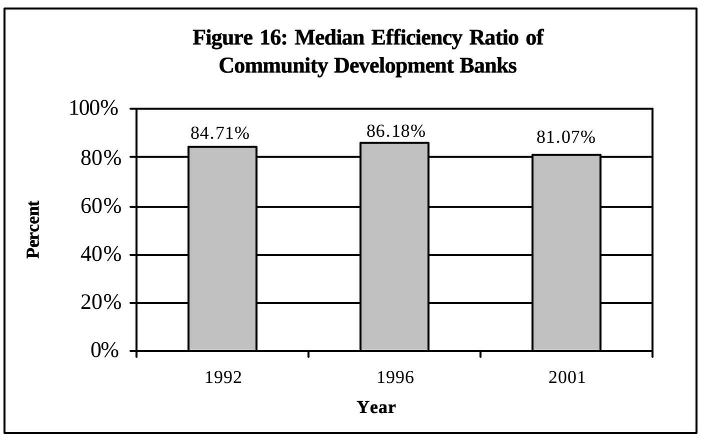
[21]Mercer, 1992.

[22]Federal Reserve Bank of Cleveland.



Efficiency Ratio

The efficiency ratio is a measure of how well a bank manages its operating expenses. The ratio shows operating expenses as a percent of the sum of net interest income and non-interest income.[23] A declining efficiency ratio indicates an increase in a bank's profitability. While the median efficiency ratio increased slightly between 1992 and 1996, from 84.71 percent to 86.18 percent, by 2001 this figure decreased to 81.07 percent (Figure 16).



Community development banks are becoming more adept at managing operating expenses, as indicated by the decreasing median efficiency ratio between 1996 and 2001. While the median efficiency ratio is still considered to be high by banking standards, it is important to point out that the community development banking is a relatively new industry. As previously mentioned, nearly one-third of all community development banks were established after 1992. New banks take time to hit their stride, but as Figure 16 demonstrates, community development banks are heading in the right direction toward increased profitability while at the same time fulfilling their community development mission.

[23]FDIC Institution Directory.

Conclusion

Community development banks have taken on the challenge of working in neighborhoods and communities that are often overlooked by mainstream financial institutions. Community development banks fulfill an important role in the communities they serve. The access to capital and credit that these institutions provide is vital to funding investments to bring about physical and economic development in the targeted community.

Over the last ten years, community development banks have grown both in number and in financial strength. On many measures of financial performance they do as well as peer institutions, despite the fact that their mission dictates that they work in economically deprived neighborhoods and take on customers that may incur higher costs and risks.

Currently, community development banks fill a small part of the total need in lower-income communities as they are few in numbers and they tend to be small institutions.[24] Mainstream institutions will have to play a larger role if low-income people are to get adequate access to fairly priced, appropriate financial products. But the growth of community development banks and their financial strength over the last decade has been dramatic. Their future growth, however, depends on a number of factors. They will need to strengthen their ties to mainstream financial institutions, thus leveraging both types of institutions' competitive advantages.[25] One key source of funds, investments, and grants from banks covered by the Community Reinvestment Act (CRA), will have to be maintained. The 1995 revisions to the CRA regulations significantly helped Community Development Financial Institutions (CDFIs) by establishing an investment test as part of a tripartite examination structure. The maintenance of the basic structure of those revisions during the 2002 CRA regulations review will be critical to the future of CDFIs. Lastly, the CDFI Fund, a key source of investments in community development banks, should be expanded. Congressional appropriations dropped from $118 million in FY 2001 to $80 million in FY 2002. Demand for these funds is more than triple the supply. The appropriation for 2003 should be increased to $125 million. Given these important contributions, community development banks could show even more striking gains in the next ten years in providing capital, credit, and basic financial services to underserved communities.

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[24]Regular banks under CRA pressure sometimes ask when the banking needs of lower-income communities will be satisfied. It is not a question they ask of other communities as they seek to create demand among their middle-income customers. The founders of South Shore Bank point out that it could be argued that all of the apparent financial service needs of the South Shore community in Chicago were being met in 1973 when the bank switched to a community development mission. But the community's economic life had faltered and the more important question was what would the community need if it had a thriving economic life.

[25]For a good summary of all types of community development financial institutions, see Mark Pinsky, "Taking Stock: CDFIs Look Ahead After 25 Years of Community Development Finance," a Capital XChange article prepared for the Brookings Institution, Center on Urban and Metropolitan Policy, Harvard University Joint Center on Housing, December 2001.

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