SOUTH SHORE NATIONAL BANK

A NEIGHBORHOOD DEVELOPMENT INSTITUTION

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He completed his undergraduate studies at the College of William and Mary, Williamsburg, Virginia, and received his M.Th. and D.Mn. degrees at the University of Chicago Divinity School.

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SOUTH SHORE NATIONAL BANK: A NEIGHBORHOOD DEVELOPMENT INSTITUTION

Summary

The authors begin with the acknowledgement that the conditions in and needs of different neighborhoods often vary considerably even within the same city, and that neither the development banking model discussed herein, nor any other "solution," can be applied across the board. Nevertheless, a discussion of the South Shore National Bank belongs in the series of papers discussing private sector initiated reinvestment strategies since it has become a national symbol for neighborhood groups, public officials and many bankers about the potential role that local financial institutions can play in revitalizing the areas in which they are chartered to do business.

Development banks are like any other commercial bank except for one important difference: <u>their primary goal is to apply their resources -- talent and credit -- to the development of their communities</u>. This does not mean that the managers of this institution eschew profit as a motivation. On the contrary, in fact, they pursue profits relentlessly, but they do so not solely in order to increase their stockholders earnings per share (as do most commercial banks), but rather to increase the resources available to rebuild their chartered service area.

This strategy is based on the assumption that banks have special institutional characteristics which make them ideally suited to the task of neighborhood development. Banks are known in their communities, and should be knowledgeable about their communities. The regulation of the banking industry is well established, and creates a system of checks and balances which helps assure the prudent use of resources. Banks control a pool of credit, and have the ability to attract additional deposits from outside the community. And finally, banks as private businesses are oriented to a pragmatic, project-by-project approach which incorporates measurable standards of performance.[1]

This paper will provide an overview of the history, management, development activities, problems and possibilities of the South Shore National Bank. It will also discuss ways in which other reinvestment strategies can be used to complement this approach to neighborhood development.

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> A little over three years ago new owners and management set out to demonstrate that an inner-city commercial bank could both succeed in the market-place and help rebuild its neighborhood . . . Earnings, development work, and deposit growth last year suggest that these dual goals are in fact compatible.
>
> --1976 Annual Report and Neighborhood Development Audit, South Shore National Bank

Introduction

South Shore is a neighborhood on the south side of Chicago which began experiencing rapid racial transition and disinvestment during the late 1960's and early 1970's. Simultaneously with the changes in the neighborhood, the South Shore National Bank experienced declining deposits and changing clientele. Deposits fell from $72 million in 1967 to $40.6 million by 1973. Total stockholder equity during the same period decreased by almost one-half.[2] Finally, in 1972 the bank applied to the U. S. Comptroller of the Currency for permission to move out of the neighborhood and to relocate in downtown Chicago.

At that point, the South Shore Commission -- a long-established community organization whose business and individual membership was also changing as the neighborhood became resegregated -- took the initiative to protest the bank's plans to abandon its chartered service area. A coalition of community groups, led by the Commission, demanded -- and got -- a commitment from the Comptroller to hold a public hearing in the community about the bank's relocation application. Finally, the Comptroller ruled that the bank had not demonstrated persuasively that it should be allowed to move, and he denied the application.[3]

At the same time, a group of investors headed by Ronald Grzywinski were looking for a bank to purchase. Grzywinski, who had served for several years as president of the nearby Hyde Park Bank and Trust Company where he had established a program of lending to minority entrepreneurs throughout the Chicago metropolitan area, had spent a year as a fellow at the Adlai Stevenson Institute in Chicago developing a proposal to establish a neighborhood development institution. It was Grzywinski's feeling that "neighborhood-based, commercial bank holding companies can assemble a unique combination of managerial and financial resources that can be used to fuse public and private programs into a coordinated thrust for neighborhood renewal, using the skills, controls, and incentives characteristic of well-managed, profit-motivated enterprises."[4]

To test his hypothesis, he formed the Illinois Neighborhood Development Corporation (INDC) as a bank holding company to purchase the South Shore National Bank.[5] The initial offering of INDC shares to raise capital to purchase the bank was aimed primarily at philanthropic sources; foundations and wealthy individuals who were sympathetic with INDC's goals, and who agreed to defer -- not forego -- return on invested equity. Using capital raised from this offering -- along with a loan from a large downtown bank -- INDC completed the purchase of the bank in August, 1973.

The first problem faced by the new management was to stop the outflow of deposits. The two-pronged strategy for accomplishing this was to increase bank services and to initiate an aggressive public relations program designed to let the community know that the bank was in the neighborhood to stay and wanted their business -- borrowing as well as savings. In addition to hiring several new tellers to speed up service for customers in the bank, Grzywinski, who served as chairman of the Bank until 1976 (he is currently chairman of the Executive Committee), and Milton Davis, Bank president, attended numerous coffees and other community functions explaining the new management's policies to community residents. In addition, the bank began extensive renovation on its own building's interior and exterior as a tangible symbol of its community commitment.

By 1975, the bank had checked the deposit outflow, and was able to report to INDC stockholders a net income of $194,000.00. By 1976, total deposits had increased by 16% since the time the bank was purchased, earnings per share stood at $4.29, the highest level in ten years, and a dividend of $1.15 per share was declared.

Development Banking

The philosophical basis for the management of South Shore National Bank is evident in their definition and practice of development banking. "Neighborhood development banking," states the Bank's 1976 Annual Report, "is 'greenlining' -- investment in the local community -- in its broadest sense. The South Shore Bank greenlines by extending credit to residents, business, and local organizations and by investing staff time to further neighborhood economic and social objectives."[8]

In practice, development banking has meant that in addition to making loans in its community, the Bank has used its other resources -- talent, institutional influence, administrative and management capacity -- to assist residents in achieving a variety of economic and social objectives. The Bank contributed staff time and its mass mailing capability to assist community groups in a campaign to prevent the City of Chicago from demolishing a complex of buildings once used as an exclusive country club. The community wanted the Chicago Park District which owns them now to convert the structures into an entertainment, conference and museum complex. The community won, and the Park District withdrew plans to replace the once elegant structures with a field house.

The Bank developed a series of brochures which inform customers about Bank charges for various kinds of savings and checking accounts, and advise them how to avoid such charges by tailoring their accounts to their individual needs and financial situation. Management and staff are made available to community organizations as consultants, and the bank conducts regular workshops on various topics such as home maintenance and "How To Balance Your Checkbook."

The need for many of these "non-bank" activities is suggested to the Bank's management by its 19-member Resident Advisory Board. Originally established as an advisory body to serve as a link between the "councils" for the nine areas into which South Shore is divided and the Bank management, the Resident Advisory Board has evolved into a monitoring and quasi-policymaking body for the Bank. Although it has no formal authority, the management is committed to responding to the Resident Advisory Board's criticisms and suggestions about Bank operations, and to providing resources to assist it in spinning-off organizations and projects that the Board deems are necessary for the comprehensive development of the community.[9] In 1976, for example, the Advisory Board served as the catalyst for the establishment of South Shore's first not-for-profit economic development group which was incorporated in September of that year with the assistance of Bank staff.

The group qualifies with the Small Business Administration as a local development company, and, as such, can serve as a conduit for low-interest, long-term loans from the SBA to businesses in the neighborhood.

Residential Development Loans

The management of South Shore Bank "broadly" considers every loan made in South Shore as a community development loan in that it contributes to the long-range economic viability of the area. For purposes of assigning staff time and resources, however, management has relegated certain loans to a Neighborhood Development Center (NDC) according to the following definition: "all new small business loans, higher-risk personal loans, student loans, and multi-family rehabilitation loans to local residents."[10] NDC operates, in other words, as a separate credit department within the bank to handle loans that normally would not be "bankable." The following table illustrates the development loan activity by type of loan during 1976.[11]

Development Loans

New Development Loans: 1976

Type of Loan	Number of Loans	Amount	%
Small Business and Community Organizations	49	$ 698,653	23.9
Mortgage	65	1,416,065	48.3
Education	169	246,518	8.4
Home Improvement	77	321,835	11.0
Development Personal	150	245,734	8.4
Total	510	$2,928,805	100.0%

Mortgage and Home Improvement Lending

Writing in what has come to be regarded as a classical text on bank management, Howard Crosse and George Hempel observe that "The form of lending [in which a commercial bank engages] should reflect the demands of the community."[12] When new management took over in 1973, there was a substantial demand for single-family financing in South Shore. Like other racially changing neighborhoods, the impacts of transition were first reflected in the price appreciation -- or lack thereof -- and maintenance of the single-family housing stock. As racial transition increased during the late sixties, prices first dipped perceptibly, then recovered somewhat as a new black market filled the void created by fleeing whites, and finally leveled off at a time when prices for comparable homes in Chicago were rapidly increasing. Home improvement loans and conventional mortgage financing were all but impossible to secure, and the community had a substantial number of Federal Housing Administration (FHA) mortgages and foreclosures.

The new management responded to the need for single-family financing almost immediately, not only because it believed that there was a creditworthy demand for homes in South Shore that was not being met, but also because management realized that this type of financing could produce substantial improvements in -- or, at least, stabilize --

the appearance of the single-family areas of the community. In addition, compared to the other two major categories of lending that obviously were necessary -- multi-family and business -- single-family loans were easier to underwrite while management became more familiar with the community.[13]

Reflecting its continuing belief that development lending should not be synonomous with easy credit, management required single-family home purchasers to put 20% down. In return, the Bank tried to be flexible in its borrower and property underwriting, but always within the bounds of what management considered prudent lending. Later, the Bank persuaded the private mortgage insurance industry to insure some single-family homes where buyers had only 15%, and, in a few cases, only 10% down.

The management's confidence that there was a middle-class market with sufficient equity -- albeit black -- for single-family homes in South Shore has been borne out. Mortgage loans outstanding at the end of 1976 totaled more than $8.5 million, 20% of which were insured by private mortgage insurance companies. Three out of five mortgage loan applications and approximately three out of four home improvement loan requests from South Shore residents were approved. Perhaps most important, however, is the fact that between 1974 and mid-1976, the median selling price of a single-family home in South Shore increased by 19%. While this figure must be used with caution since prices doubled during this period in the most prestigious section of the community, the trend in price appreciation is clearly upward.[14]

Rehabilitation of Multi-Family Dwellings

Much of present South Shore was constructed between 1910 and 1939, and there has been little new construction since that time. Only six percent of the housing stock is less than ten years old. The vast majority of the community's housing is located in rental structures. Of 22,000 units constructed before 1939, for example, more than 81 per cent were multi-family, and that same proportion held for construction post 1939. Today, the community's housing stock consist of approximately 32,000 units, 82.5% of which are rentals. The bulk of the rental units are located in buildings containing five or more apartments, and more than one-fifth are in buildings of 50 or more units.

More important than the number of multi-family units, however, is their distribution. While there are sections of the community which have a predominance of rental buildings, South Shore was built in such a way that large multi-family structures anchor the corners and mid-blocks of many single-family sections. This has made it difficult to stabilize these blocks because of the presence of deteriorated -- and sometimes partially abandoned -- 24 and 36-unit apartment buildings. The problem is exascerbated by the fact that demand for multi-family units is weak due to the renovation needs of many buildings.

In response to this dilemma, Bank management has tried a variety of strategies to get multi-family buildings rehabilitated. For example, the Bank financed the renovation of a 39-unit building for conversion to condominiums, and then provided mortgages to qualified purchasers. Several smaller buildings also have been renovated and converted to condominiums. In addition, South Shore Bank is one of the few commercial banks in Chicago which makes loans to buyers of units in buildings that are cooperatively owned.[15]

The Bank also has cooperated with a service corporation consisting of 60 Chicago area savings and loan associations in its efforts to rehabilitate more than four hundred rental units with financing from the state housing finance authority in one section of the community.[16] Simultaneously, the bank actively sought to identify and encourage several local residents to buy and rehabilitate other multi-family buildings in the immediate area, thereby creating a critical mass both in terms of demand and price appreciation.

Recognizing that traditional banking practices provided little guidance for coping with the magnitude of the problem of multi-family buildings in South Shore, the Bank sought and received a $20,000 foundation grant to establish an experimental program known as the Parkside Banker. Parkside is the most deteriorated section of South Shore largely because it was the first area to undergo racial transition, and hence the first area from which conventional credit was withdrawn. It is predominantly a multi-family area in which a high proportion of the structures are tax delinquent and absentee-owned. The purpose of the Parkside Banker Program was to put a bank officer in the area on a full-time basis for a period of time to develop better information about the credit needs of those resident owners that are still in Parkside, and to increase Bank management's awareness of the magnitude and range of problems which must be addressed before any significant investment in the area can be made.

While not as apparent to the observer as is the stabilization of the single-family stock, as of the end of 1976 there had been modest progress in addressing the multi-family housing problems of South Shore. Twelve buildings had been rehabilitated and converted to condominiums. More than 600 rental units in twelve buildings had been rehabilitated, and another 208 units were in process.[17] While the bank did not finance all of these units, the management feels that the presence of the Bank, and its development lending commitment played an important role in attracting the other institutions that did the rehabilitation.[18]

Development Deposit Program

Disinvestment from neighborhoods occurs for a variety of reasons. In the case of South Shore -- and other older communities that undergo rapid racial transition -- Grzywinski describes the process of disinvestment and deterioration as follows:

> As a neighborhood grows older, it loses its ability to compete with newer neighborhoods for higher income residents, services, and economic investment. The inability to compete sets up a process of deterioration that is often accelerated by (1) market forces which operate independently of social objectives, (2) racial separation and unequal opportunity, and (3) unresponsive public institutions. Each of these factors reinforces the others to create an accelerating spiral of neighborhood decay.[19]

One aspect of the "downward spiral" is the perception on the part of most of the actors involved -- residents, business persons, government officials, landlords, realtors, appraisers, as well as lenders -- that further decay is <u>inevitable</u>. This belief forms the foundation for the assumption that the risks of investing in older, low- and moderate-income, minority or racially changing neighborhoods are unacceptable.

In contrast to this attitude, the Bank's management -- based largely on Grzywinski's previous experiences lending to minority entrepreneurs in a number of inner-city areas -- started with the assumption that the risks of lending in South Shore <u>might</u> be greater in certain cases due to the recent history of public and private disinvestment. The management was convinced, however, that credit nevertheless could be extended prudently in the vast majority of instances if bank officers and staff did careful, individualized underwriting, and "relied heavily on public and, to a lesser extent, on private credit co-insurance programs, e.g. Small Business Administration (SBA) guarantees, Federal Housing Authority [sic.] (FHA) insurance, Illinois student loan guarantees, and private mortgage insurance."[20]

Although the Bank can reduce risks to manageable levels in this manner, the resulting loans are often more costly -- and, therefore, less profitable -- than alternative investments outside the neighborhood. This lower profitability results from several factors. Personnel costs to qualify and counsel borrowers are higher. The extensive application procedures for public coinsurance programs are time consuming. The principal balances of development loans are often so small that interest income does not offset the expenses of making the loans. Accounting and data processing costs are higher when many small loans are made. Finally, although it is difficult to quantify with precision, there is the "lost opportunity cost" the Bank incurs when it invests in long-term, fixed-rate residential loans in its neighborhood rather than lower-risk, higher yield money market instruments.[21]

In order to offset these higher costs and avoid a drain on profits from other banking operations, the management uses a development deposit program pioneered by Grzywinski during his tenure as president of Hyde Park

Bank to support its Urban Development Division. Development deposits are defined as deposits coming from outside of South Shore which are solicited for the express purpose of supporting the Bank's development activities. These deposits -- which pay the same rates and include the same services as regular deposit accounts -- come from individual, institutional and public sources. This program is effective, because depositors are protected up to $40,000 per account by the Federal Deposit Insurance Corporation (FDIC) just as they would be at any other financial institution, and because the management places high priority on keeping development depositors informed about the Bank's progress and development activities.

Bank earnings on development accounts are used to offset additional costs involved in making loans through the NDC. Eventually, the Bank expects that the earnings from this program will cover all of the routine development expenses, and even generate additional "development dividends" which can be used to finance additional activities.[22] According to the Bank's 1976 Annual Report, development deposits which accounted for one-third of the growth in total deposits increased by 45% during the year to a total of $7.8 million, and generated almost $58,500 income for the NDC.[23]

Neighborhood Development Audit

In the opinion of management, development banking at

South Shore includes two unique components: Development deposits; and, development reporting.[24] As with the development deposit program, the impetus for the reporting system came from Grzywinski who asserts that in order "to build mutual confidence and trust" between a neighborhood development institution and its stockholders, development depositors, customers and neighborhood residents, it is imperative that "the costs and profits of development . . . be accurately and publicly reported."[25] For this reason, the Bank publishes each year a "Neighborhood Development Audit." The Audit is included with the current year's annual report, contains detailed itemization of development income and expense, and -- like the financial statements for the Bank -- includes a letter of opinion from the Bank's independent auditors attesting to the fairness of the financial data presented.

Conclusions

The management of South Shore National Bank appears to have broken new ground in turning a privately capitalized, for-profit institution into a vehicle for community development. It is too early to evaluate the extent to which the Bank will be able to restore the South Shore neighborhood's ability to compete successfully for private capital and credit. It is also premature to determine whether or not one of the unintended consequences of doing so successfully will be the displacement of all or a portion of the approximately twenty percent of residents who currently are receiving public assistance. Nevertheless, it is possible to assert that the Bank has set a new standard of responsiveness for inner-city financial institutions. One of the Bank's board members described this important accomplishment in the following way:

> The persistent drive for profitability while at the same time "greenlining" is leading to a new understanding of how both the public and the private sectors' systematic bias against inner-city redevelopment can be reversed.[26]

Due to the widespread optimism about the South Shore Bank model, however, it is important to consider what the senior management of the Bank thinks about its success to date, its limitations, and its replicability.

Consistent with his original plan for creating a neighborhood development institution, Grzywinski continues to feel that "A commercial bank, operating by itself, is an incomplete vehicle for neighborhood development." This assumption is based on the following:

> A true development bank should be an innovative institution which continuously infuses capital, long-term credit, and technical assistance into social and economic improvement projects. It should possess the capacity to initiate development projects when other initiators are unavailable.
>
> By law, commercial banks are limited to the business of banking. However, the Board of Governors of the Federal Reserve System has ruled that bank holding companies may invest in community development corporations. Such non-banking subsidiaries can be organized as initiators of development projects and as sources of venture capital. They

> then complement the banking subsidiary and expand the options available to the parent /_holding company_/. 27

In addition to the need to have non-bank community development subsidiaries created by the managers of bank holding companies which are serious about having their banking subsidiary do neighborhood development -- Grzywinski's INDC applied in August, 1977 to the Federal Reserve Board for permission to establish both a for-profit and a not-for-profit subsidiary -- Grzywinski also believes that additional public incentives are needed to encourage "the investment of private capital, credit and talent resources to revitalize our urban neighborhoods."[29]

Four incentives he has suggested that states might provide to financial institutions that are engaged in community development activities are as follows:[30]

> 1. A system of coinsuring development credits. As mentioned above, one of the factors which increases the costs of development lending is the complexity of processing public insurance. States could establish a system whereby financial institutions could automatically obtain state insurance on a variety of development credits if these institutions are willing to assume a larger percentage of the risk, e.g. twenty percent. Financial institutions would apply to the appropriate state agency, and be covered by a master policy similiar to that used by private mortgage insurance companies. The twenty percent exposure of the institution would help assure that credits are underwritten prudently.
>
> 2. Secondary market for development credits. The purpose of a secondary market is to allow a financial institution to regain liquidity lost when certain types of loans are made. This permits the institution to sell loans, and use the proceeds to make additional credits. A state-run secondary market that would buy a portion (say 75%) of a package of development loans

would provide a tangible incentive for banks to do increased development lending. The purpose of limiting the percent of the loan package eligible for sale in the secondary market would be to insure that the lender has an incentive to underwrite the loans prudently.

3. Grants to development banks to cover the additional costs of making development loans. If development activity is going to take place on an extensive basis, the development deposit program may not generate sufficient earnings to cover development lending costs. Since development banks contribute to the economic revitalization of communities -- thereby increasing the taxes generated from communities, and decreasing the amount of transfer payments going into communities -- states could justify such grants as being in their long-term economic self-interest.

4. Issuing tax-exempt development bonds. States that issue such bonds could raise funds that could be loaned to development banks at below-market rates. The banks, in turn, would make these funds available to neighborhood users at lower-than-market rates.

In conclusion, it is appropriate to note that in the letter to stockholders accompanying its 1976 Annual Report and Neighborhood Development Audit, senior management of South Shore National Bank made the following observations:

> Favorable beginnings, however, do not justify undue optimism; the most difficult work lies ahead. Long-term recovery will require extraordinary economic and non-economic efforts in commercial and multi-family residential rehabilitation, crime prevention, and school improvement. The Bank's activities are only part of the process involved in redeveloping South Shore. But it is clear now that reinvestment of private resources through publicly regulated financial institutions can be a prime factor in renewing urban neighborhoods.[31]

Footnotes

1 Ronald Grzywinski, Memorandum Re: "Bank Holding Companies as Neighborhood Development Corporations," 1 January, 1976, pp.1-2.

2 South Shore National Bank of Chicago, 1976 Annual Report and Neighborhood Development Audit, p.24.

3 Opinion of the Comptroller of the Currency, Administrator of National Banks, William B. Camp, in the matter of the application of South Shore National Bank to relocate, 5 December, 1972.

4 Ronald Grzywinski, Testimony before the U.S. Senate Banking Committee on the subject of Neighborhood Preservation, 14 June, 1976, pp.1-2.

5 See Part III, Chapter 6.

6 SSNB 1976 Annual Report, p.24.

7 *Ibid.*, pp.24,17.

8 *Ibid.*, p.10.

9 Rosa Moore, member, SSNB Resident Advisory Board, in remarks before "Banking for Non-Bankers Conference" in Chicago, Illinois, 6 June, 1977.

10 SSNB 1976 Annual Report, p.10.

11 *Ibid.*, p.11.

12 Howard D. Crosse and George H. Hempel, *Management Policies For Commercial Banks* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1973), p.192.

13 Thomas O'Reilly, Vice President, South Shore National Bank, in remarks before "Banking for Non-Bankers Conference" in Chicago, Illinois, 6 June, 1977.

14 SSNB 1976 Annual Report, p.11.

15 Financial institutions often refuse to make loans to buyers of cooperatively owned apartments since the purchaser never holds title to the unit, only shares of stock in the corporation. These often are not suitable collateral since most cooperatives have a clause in their by-laws prohibiting members from assigning shares as collateral. SSNB's policy is to take an assignment of shares if it can be obtained, but in any event to hold the shares at the Bank in order to make it more difficult to sell the unit without Bank approval. As of November 8, 1977, it is possible to obtain FHA insurance to purchase cooperative apartments. This should make it easier for purchaser and financial institution to make this type of investment.

16 See Part III, Chapter 5.

17 SSNB 1976 Annual Report, p.1.

18 Ronald Grzywinski in remarks before "Banking for Non-Bankers Conference" in Chicago, Illinois, 5 June, 1977.

19 Grzywinski, U.S. Senate Banking Committee Testimony, p.1.

20 Ibid., p.3.

21 SSNB, 1975 Neighborhood Development Audit.

22 SSNB, 1976 Annual Report, p.13.

23 Ibid., p.1.

24 Ibid., p.10

25 Grzywinski, Memorandum Re: "Bank Holding Companies . . .," p.4.

26 SSNB 1976 Annual Report, p.13.

27 Grzywinski, Memorandum Re: "Bank Holding Companies . . .," p.3.

28 See Part III, Chapter 6.

29 Grzywinski, U.S. Senate Banking Committee Testimony, p.1.

30 Ibid., pp.4-5.

31 SSNB 1976 Annual Report, p.1.