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Useful Lessons for CD Bankers

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Bernard Edmonds, owner of Masters Home Improvement Company, equates his company's growth to his enthusiasm for construction combined with Shorebank's vision for a revitalized Detroit. Mr. Edmonds attributes his most recent surge in business to hard work and help from Shorebank's Contractor Equity Program.

I've learned some constructive lessons during 25 years in community development banking at Shorebank Corporation, Southern Development Bancorporation and the National Community Investment Fund (see electronic article "National Community Investment Fund: Financing Depository CDFIs Nationwide"). Certainly, the road to establishing a successful community development bank can be rough. But the obstacles are ones that Shorebank and others have met.

Confronting the start-up challenge

De novo community development banks, like their conventional counterparts, face the tasks of simultaneously raising a substantial amount of equity, building a significant book of loan and deposit business and developing a first-class customer service team — all while maintaining high asset quality and a low efficiency ratio.

CD banks must strive to accomplish these goals and reach a self-sustaining scale while, at the same time, addressing several potential disadvantages:

- The sources of capital for *de novo* CD banks are limited, and some investors may expect unrealistic financial and development results within a short time frame.
- Initially CD banks may need to derive most of their deposits from outside their primary service area, typically from socially motivated investors who are likely to make deposits in large amounts and in the form of certificates of deposit. While this may help diversify the deposit base and reduce servicing costs, it can increase interest expense and may raise the eyebrows of regulators concerned about "hot money" deposits in *de novo* institutions.
- *De novo* CD banks tend to have a hard time identifying good loan prospects at the outset. After all, one reason why the communities they serve are underbanked is that there is limited effective demand for conventionally attractive loans. It took Shorebank 15 years to fully develop its most profitable product — loans for multi-family residential rehab projects — and getting there meant working through high levels of loan losses and delinquencies. In contrast, many conventional *de novo* community banks can take advantage of their founder's prior deposit and loan relationships.

True, they may face more competition, but because they generally serve higher-income markets they have the prospect of higher deposit balances and less challenging credits.

- *De novo* CD banks may have difficulty recruiting senior staff. Unlike conventional start-ups, they can't woo key employees with expectations of future gains on stock options or founders' shares. Instead they must look for people with a strong commitment to the communities they will be serving often without extensive conventional banking backgrounds — and while this can produce a stronger bank in the long run, it probably means incurring higher initial and ongoing staff training costs.
- Similarly, it can be hard for *de novo* CD banks to recruit qualified board members, in part because of the risk of being exposed to substantial personal liability if the bank fails, and because CD banks by definition serve markets considered high-risk.

Watch out for the wall

De novo CD banks may experience strong growth at the outset but then, like a long-distance runner, "hit the wall" before they've really hit their stride — that is, before achieving the asset levels they need to ensure sustained profitability.

They've successfully maneuvered their way through start-up, grown to $30-50 million in assets and achieved break-even operations, but then falter. In the National Community Investment Fund's (NCIF) experience, CD banks generally need to reach $100 million in assets to absorb the higher costs of serving low-income customers (lower deposit balances, higher number of transactions, high levels of deposit account churn, fewer loans making the grade from prospect to closing, lower loan balances, etc.) to achieve sustainable profitability without the benefit of BEA awards. That second $50 million in growth is turning out to be a big hurdle.

As noted above, another stumbling block is retaining executive officers. NCIF generally sees executive base salaries for $30-60 million CD banks in the $75K-125K range. Although this is well within the norm for executives of conventional community banks of similar size, CD banks typically lack meaningful short- or long-term incentive compensation plans. Yet the job is arguably harder. Unless executives are powerfully motivated by their sense of mission, it can be difficult to keep them in place.

Getting help

Being a CD bank executive can be lonely because there are few vehicles through which they can obtain needed technical assistance and management support. NCIF has tried to fill this void with its network for senior managers.

Although it may seem logical that officers of large banks that have invested in a CD bank would be good sources of substantive management assistance, for various reasons that's not always the case. The investing institution may be solely concerned with meeting its CRA compliance requirements, or it may be concerned that regulators will hold it responsible if the CD bank underperforms.

Nevertheless, CD bank executives have often developed supportive relationships with individuals from other financial institutions. Shorebank is a textbook example. For many years, Bill Goodyear, formerly CEO of BankAmerica Illinois, George Brookes, formerly CEO of Huntington Bank Cleveland, and, until his death, Steve Diamond of American National Bank of Chicago have been key advisors to Shorebank's bank boards. Their experience — and that of many other bankers — is

proof that nurturing and mutually rewarding relationships can be built between conventional banks and CD institutions.

Focus and discipline

Finally, it's clear that CD banks, like all businesses, need focus and discipline to succeed. While it's true that every neighborhood served by a CD bank is unique, the bank's products do not necessarily have to be. The first step in achieving focus and discipline is for the CD bank to identify a product niche. Then it must carefully assess the risks and pitfalls of offering that product, including the bank's capacity to deliver it. Then the bank must develop standards of risk tolerance and methods to mitigate risks. After that, it becomes a question of rigorous execution. Ideally, the process of community-building and bank-building becomes synergistic as every loan made by the CD bank builds on the success of its prior loans.

Having a disciplined approach doesn't preclude a CD bank from having unusually deep and close relationships with its customers. But it avoids the pitfall of trying to be all things to all people. It's hard work, but when you think about it, it's what CD banks are all about.

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