FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 8, Issue 4 Community Development Lending: Profit or Cost Center?

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Fall 1996

It's not easy pondering the profitability of community development lending while sitting on a beach under the hot sun of the Atlantic coast. But in the aftermath of a rather spirited debate on the subject (one which left its participants with more questions than answers!) I agreed to document my opinions in an article for the Fed newsletter. It just so happened that in the middle of all this, my previously scheduled vacation arrived. No problem, I thought. When I get to the beach, I'll reflect on my ten years of experience in community development lending and I'll conduct a bit of impromptu research.

So that's just what I did... "Do you think community development lending is profitable?" I asked my fellow beachgoers. The best response I got was from a guy named Rick. "Hey," he said, sipping a cold drink, "If you lend money and get it back, then everything should be cool." While his answer wasn't exactly the analytical response I was looking for, it was a good reminder that there are still serious misconceptions about lending and its profitability. You see, our specific issues as community development lenders may have a limited scope in the context of broader banking issues, but within that scope, profitability is an issue we must continually address.

In our business, profitability is most often measured by two things. One is a loan's individual performance. The other has a much broader context--that is, those activities a bank considers to be part of its overall community development lending strategy. We could, therefore, be assessing the profitability of an entire institution if it is a community development bank. Or, we could be examining the performance of a specific department within a larger bank structure. Or, we could be analyzing the performance of a single loan portfolio handled by one or two people. This kind of disparity means that we must be careful about how and what we measure when we attempt to ascertain the profitability of community development lending.

We often hear from bankers that they are making money in community development lending. What we do not often hear is how they arrived at that conclusion. There are still lenders in our field who believe they will make money on community development loans simply if the following happens:

- The loan is repaid in a timely fashion;
- The loan has market rate terms and conditions, and a loan fee was received;
- The bank uses one officer, not three, to underwrite one loan;
- There aren't any special events or groundbreaking ceremonies that the bank has to sponsor.

While these points have some merit, they do not accurately reflect or account for time--the time it takes to structure a deal on the front-end; the time it takes to close a loan; the time of others involved in the approval process; and the time needed to handle additional loan servicing after the loan has closed. We do not have a consistent method of accounting for the time spent on community development loans, and it would be helpful for those of us in the business to review and agree upon a set of evaluative conditions by which to measure time spent. By doing so, perhaps we will be better able to make the case that our overall business can be, and often is, profitable.

Why Community Development Lending May Not Be Profitable

Before I offer my suggestions for how to measure profitability, I'd like to briefly summarize the issues surrounding the notion that community development lending won't ever be profitable. There are still community development lenders who believe that "this kind of lending" is so labor intensive that the cost of loan production will never be justified by the rate of return on the loans. Unfortunately, many of these lenders may be jaded by CRA agreements wherein their bank committed to provide a certain number of below-market rate loans for the purposes of community development. By agreeing to a lower interest rate, it stands to reason that associated costs will be more difficult to cover. And, because CRA agreements tend to be widely publicized, other banks in the area may feel pressure to offer the same kind of discounted financing. It's never fun to receive a call from customers asking for "that cheap CRA money," and it's never fun to squeeze profit from a below-market rate loan.

In addition to below-market rate loans, there are other factors that may work against profitability. Many banks host special activities or ribbon-cutting ceremonies to highlight the good work they are doing in a community. These activities are fine, but they take staff time and money. Why not have the marketing department handle the arrangements and absorb the associated costs of these events?

In the process of structuring a loan, a bank may agree to pay for specific origination costs like legal, appraisal and other expenses typically passed on to the borrower. To make matters worse, there are banks that waive their loan fees entirely for community development loans! We work for our money, so I make sure we get our loan fees. Since when does the "C" in CRA stand for concessionary?

Although costly concessions like the ones indicated above will adversely impact profit, lenders often equate a lack of profitability with specific loans that are not performing well. Somewhere along the line, community development loans were labeled "risky" and lenders assumed that these loans would have a greater incidence of delinquency or default. It's true that when you've been around long enough to originate a substantial number of loans, you will encounter these problems. But how much delinquency is there? From what lenders say to me, problems with soundly underwritten community development loans occur less frequently than do problems with other, more conventional loans. Taking lenders' conversations as sufficient evidence for now, I think it's safe to say that once booked, the loans themselves do not automatically have a negative impact on overall profitability--unless of course, the loan carries a below-market interest rate. Rather, what may most affect profitability is a bank's long-term servicing efforts as well as the existence of other subsidies or credit enhancements in a deal. Both of these factors are commonplace in community development lending, but they require ongoing time and attention from a loan officer.

Regardless of where we think we are in the profitability spectrum, we'd probably all like to be more profitable, both in terms of individual loan performance and in terms of the community development lending department and its programs. We need to talk about profitability more often. At conferences and in other settings, we spend a lot of time on programmatic topics such as subsidies and loan products. These are important, but so are actual administration issues such as how to underwrite and structure loan risk, how to deal with loan servicing and work-outs and, of course, how to assess loan profitability.

It would be interesting to review reports from banks that evaluate their loans in terms of profitability. In addition to examining (and perhaps standardizing) the evaluative conditions set forth in the reports, the information would be helpful for lenders whose banking institutions still hold negative perceptions of community development lending.

The more profitable we are and the more information we have to share, the more leverage we have within our banks. That translates into doing more in our communities.

Which reminds me... the "C" in CRA? It stands for Community.

Karen's Top 10 Ways to Make Money While Lending Money

1. Use an internal profitability analysis chart to track each loan. Set a profit goal for each one and attempt to stick to it. If you want to make an exception for the social service agency that tugs at your heartstrings, go for it... with the understanding that you'll make it up elsewhere.

2. Develop an annual budget for all your community development lending expenses and measure these against the loan returns. Be very clear as to what is and is not included on both the income and expense sides of the budget, and for what you are accountable.

3. Develop a budget for indirectly related expenses such as loan marketing and promotion. These expenses should be absorbed by the public affairs or marketing departments, or in the case of small banks, as part of the general overhead expense. Before the days of community development lending, banks created and paid for all lines of business development products. (I can still recall my days delivering golf balls and umbrellas to potential customers). As much as possible, let's try to keep it that way.

4. Make sure your customers pay for all their loan closing expenses, and whenever possible, have them take you out. You may have to eat a lot of pizza, but you'll save money. And, while fee waivers are nice, they dig deep into your bottom line.

5. Carefully analyze the number of loan officers vis-a-vis the size of your portfolio and budget. If you're starting a lending group, you can either staff-up on the front end without making any real money for a while, or start very small and add staff and other expenses as the portfolio grows. I recommend the latter.

6. Make sure you price loans so that you make an acceptable return from each one and do as much volume lending as possible. Some loan officers complete forms highlighting the anticipated return on each loan. This seems to be a good, basic tool to use. If you aren't sure how to do it, check with any traditional commercial or real estate lender in your bank.

7. If you need or want to make a loan with some concessions, be sure to offset it with other profit-driven loans. Limit concessionary or very time-consuming loans to a certain number each year.

8. Make sure you separate CRA compliance and other non-lending work from the business of originating community development loans. Some banks have one department doing both. Corporate contributions, regulatory compliance, and those huge cardboard checks should not be expensed to the community development lending department.

9. Review your budget and profitability goals on a quarterly basis. If you are doing well, go out and celebrate. If you are behind, do not go out! Stay in the office, and bring in pizza. Eventually, you'll reach your profitability goals and you'll need to establish new ones.

10. Attend training sessions and conferences sponsored by the Federal Reserve Banks. The information you bring back should offset the expense of attending... and the Fed did not pay me to say this!

About the Author:

Karen Kollias is Senior Vice President and Director of Real Estate Lending for Shore Bank & Trust Company in Cleveland, Ohio. The mission of the bank and its real estate group is to extend credit to community development projects located in the eastside neighborhoods of Cleveland. Prior to joining Shore Bank and Trust in 1995, Ms. Kollias developed and managed the community development lending group for the mid-atlantic region of NationsBank. During her eight year tenure there, the group originated nearly $300 million in community development loans serving the state of Maryland, Washington, DC and Northern Virginia. Ms. Kollias is also a public speaker, trainer and author on topics related to community development lending and public/private partnerships.