COMMERCIAL BANK LENDING PRACTICES IN THE DEVELOPMENT OF URBAN PROJECTS: UNDERWRITING CRITERIA IN A CHANGING ENVIRONMENT

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ABSTRACT

This thesis describes and analyzes how commercial banks underwrite loans issued in disinvested urban areas using underwriting criteria which stray from traditional underwriting criteria. These types of loans are referred to as non-traditional or community development loans.

Bank lending practices have contributed to disinvestment in certain inner-city neighborhoods due to lender's perception of higher risk and lower property values. The shift in bank lending patterns away from inner-city communities paralleled the decline of the urban core.

Heightened pressure stemming from federal legislation and public and private initiatives in Boston to enhance lending opportunities to lower-income populations, has resulted in greater efforts to provide credit in Boston's urban neighborhoods. However, increased regulation of financial institutions has made it difficult to underwrite non-traditional loans.

Non-traditional lending in Boston will become very difficult in the 1990s. As stricter regulations are imposed on commercial banks, lenders will lose the flexibility needed to issue these types of loans. As public sources of financing diminish, the financial viability of these types of loans will decrease. The city of Boston continues to

demonstrate its commitment to reinvestment through the creation of programs intended to combine public and private expertise and resources.

In order to replicate the Boston experience in other cities, four key components must be present: (1) a strong commitment of the city, the banking industry, and local developers to reinvest in inner-city neighborhoods; (2) a combination of public and private funding sources; (3) community organizations must work in partnership with the city and banking industry to implement city initiatives similar to those in Boston; and (4) a willingness on the part of lenders to maintain flexibility in underwriting criteria used to process non-traditional loans.

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1.0 INTRODUCTION

The purpose of this study is to describe and analyze how commercial banks underwrite non-traditional loans in inner-city neighborhoods. For the purposes of this study, non-traditional loans, sometimes referred to as community development loans, are defined as loans issued in disinvested urban areas with underwriting criteria used which stray from traditional underwriting criteria. For example, as illustrated in the case studies presented in chapter four, banks may reduce the required debt coverage ratio (DCR) if a developer has a certain percentage of a building pre-leased. Or, a higher loan-to-value ratio (LTV) may be approved if the city made a financial commitment to an inner-city project. Other methods used to substitute underwriting criteria, in order to make non-traditional loans viable, are presented in this study.

As federal and state resources continue to diminish, the lending community has been asked to assume more responsibility for lending in urban neighborhoods. Some of the recent pressure is a result of the Community Reinvestment Act of 1977, designed to require lenders to meet the credit needs of their communities. In July, 1990, stricter disclosure legislation was passed. In Boston, several city initiatives have provided some incentive for banks to participate in non-traditional lending.

At the same time, however, increased regulation of financial institutions, including banks and thrifts, has created a difficult environment in which to maintain flexibility in underwriting criteria needed to process non-traditional loans. Since bank examiners and regulators were sobered by the Savings and Loan (S&L) crisis of the mid 1980s, first in the southwest, they now want to prevent it from recurring with the same impact in the northeast. Therefore, standards have been tightened and banks are being examined with more rigor. The effect on the availability of credit for real estate-related ventures caused by the tighter regulations is

the subject of many arguments among lenders, regulators, and developers.

This study is presented in five chapters. Chapter one sets the national historical context in which to evaluate current lending patterns and criteria. The history of the decline and subsequent disinvestment of urban areas and the impact of this decline on commercial banks' lending patterns and policies is outlined. Specific examples from the Boston experience are documented.

Chapter two defines the problem associated with disinvestment in inner cities: lack of affordable, available financing. Efforts to change lending practices, focusing on national legislation and Boston city initiatives, are described as vehicles to remedy the problem defined earlier.

Chapter three provides a comparison of underwriting criteria used for traditional and non-traditional loans. An understanding of underwriting criteria is critical for chapter four, in which the case studies of three Boston-based commercial banks and five loan transactions are presented. Finally, from the information provided in chapter four, chapter five analyzes the loan transactions in order to determine whether or not they could be issued in today's environment.

Methodology

In order to understand how commercial banks underwrite non-traditional loans and to what extent their issuance will occur in the future, case studies of three banks and five loan transactions are presented. The case study method of research was selected to provide a framework in which to compare and contrast how different banks operate and what criteria are used in their evaluation process. The case studies are based on a variety of data including written information from banks as well as interviews with bank

representatives, developers, and public and quasi-public agencies. The interview method was chosen to supplement information pertaining to each loan transaction. The three banks used for the case studies are Boston-based commercial banks, conducting lending business in Boston urban neighborhoods, including Roxbury, Dorchester and the South End. The loan transactions were all issued within the last five years.

As part of the methodology, a literature review was conducted on commercial lending patterns and practices, underwriting criteria for traditional and non-traditional loans, federal, state, and local efforts to enhance public and private reinvestment, and regulatory activity as it pertains to financial institutions. Works presented by Karen Kollias in her working paper entitled, "Community Development Lending: Cutting Edge for Good Business"[1] and a process model by C.P. Line and C.E. Riesenberg entitled, "Principles and Practices of Community Development Lending: A Five Step Investment Model to Strengthen Bank Community Development Programs"[2] were used to outline a framework for understanding traditional and non-traditional underwriting criteria.

In addition, extensive interviewing was done with Boston lenders, developers, and public and quasi-public agency officials. Eighteen lenders, including workout specialists and community development lending practitioners, were interviewed for this research. The banking experience of the interviewees ranged from one year to over twenty-five years. Professional positions ranged from assistant vice president to division executive.

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1 Karen Kollias, "Community Development Lending: Cutting Edge for Good Business", (Washington: American Security Bank, 1988).

2 C.P. Line and C.E. Riesenberg, "Principles and Practices of Community Development Lending: A Five Step Investment Model to Strengthen Bank Community Development Programs", (Minneapolis: The Federal Reserve Bank of Minneapolis and First Bank System, 1989).

Generally, the interviews focused on construction lending, although mini-perms and end-loans were also discussed. While the Boston bankers interviewed took a conservative position on underwriting criteria, most indicated that they utilize several non-traditional mechanisms in the underwriting of community development loans. Many of the lenders could not speak of their lending underwriting without making reference to the current market conditions. Several expressed concern about community development lending within the context of the current regulatory environment and real estate lending market.

In addition to the interviews with lenders, seven developers (five non-profit and two for-profit) and four public and quasi-public agencies were interviewed for this research. All of the interviews were conducted confidentially which made frank discussion of lending practices possible.

1.1 DECLINE OF URBAN AREAS

As the exodus from the industrial cities in the northeast and midwest continued to occur throughout the 1950s and 1960s, there were tremendous shifts in population and employment. Suburbanization reached heightened levels by the 1960s adding to the losses in population and employment. Those with the means to move out of urban areas during this period were, for the most part, white. On the other hand, many blacks were moving into the inner city looking for employment opportunities. "As predominantly white middle-income groups have dispersed from the cities...they have been only partially replaced be predominantly lower-income minority groups..."[3] Highways and transportation systems made commuting from the suburbs to inner city employment more

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3 John D. Kasarda, "Urban Change and Minority Opportunities" in Paul E. Peterson, ed., *The New Urban Reality,* (Washington: The Brookings Institution, 1985), 33-34.

accessible, thereby allowing those with means to live outside of the inner city. These changes contributed to the decline in the inner cities, particularly the Snowbelt cities of the northeast and the midwest.

During the 1960s many of these Snowbelt cities became predominantly black. At the same time, there were drastic changes in employment activity in the city. Many manufacturing firms and wholesalers moved out to the suburbs due to lower taxes, cheaper rents and lower transportation costs. This demonstrated a real decrease in blue-collar jobs for inner-city residents and a decline in tax-producing activities. "Most large cities in the Northeast and Midwest lost manufacturing jobs faster than they gained white-collar work, leaving them with fewer jobs overall."[4] In Boston, during the period from 1967 to 1977, employment changes in the central city decreased in the manufacturing, wholesale, and retail sectors.[5] "Two types of urban change have left America's older industrial cities in severe decline: technological innovations in transportation, communication, and manufacturing have made their infrastructure and land use patterns obsolete, and accelerating racial change has made inner cities the primary home for minority groups, particularly those with low incomes and poor job skills."[6]

In Boston, during this time period, the same phenomenon occurred. As industry left the inner city for less expensive locations along the new Route 128 highway, middle-income whites followed. "The historic pattern of suburban residents commuting to the city, to the white-collar jobs, changed when industry moved out to the suburbs. During the 1970s, Boston experienced a large decrease in jobs, industry and income. This continued until 1975 when the high-tech

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4 Bernard J. Frieden and Lynn B. Sagalyn, *Downtown, Inc. How America Rebuilds Cities,* (Cambridge: MIT Press, 1989), 288.

5 Kasarda, "Urban Change and Minority Opportunities", 44.

6 Paul E. Peterson, *The New Urban Reality,* (Washington: The Brookings Institution, 1985), vii.

industry boomed. Now, however, the city is experiencing another decline."[7] By mid 1980s "...persistent underemployment and poverty and a mismatch between the skills and experience of the minority labor force and the types of jobs that are growing fastest in Boston's transformed economy were evident in 1985."[8] Many of the larger chain stores relocated to the suburbs, while small business investment declined and many commercial businesses were unable to survive. In addition, the housing stock suffered and property values decreased. As a result, inner cities decayed and disinvestment occurred.

Disinvestment

The term disinvestment refers to the unavailability of credit for mortgage finance and lack of private and public investment in certain urban areas. It is a phenomenon which continues to occur in certain inner-city neighborhoods. Disinvestment "concerns the general failure of landlords, lenders, business and local government to make investment in particular areas because of their pessimistic evaluation of that neighborhood's future."[9] This creates a difficult environment in which to obtain financing.

Lenders perceived inner city communities to be high risk areas in which to make loans. "...there is little question that the economics of financial risk, either real or perceived, is at the heart of the disinvestment problem."[10] Lending institutions, therefore, invested mainly in new construction going on in the suburbs, regardless of where their depositors were from, and left the inner city

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7 Personal interview with Mark J Waltch, Financial advisor to national developers and financial institutions; July 9, 1990, Boston.

8 Jeffrey Brown, "Indicators of Minority Participation in Boston's Growing Economy", (Boston: Boston Redevelopment Authority Research Department, 1986), 2.

9 Urban Consortium, *Disinvestment in Urban Neighborhoods,* (Washington: Public Technology, 1977), 1.

10 Ibid., 7.

communities without affordable financing sources.[11] By denying certain communities access to affordable financing, lack of financing contributed to the deterioration of neighborhoods. "...lending institutions contribute to the declining quality of life in certain urban neighborhoods by refusing to grant mortgages even though demand exists,..."[12] The more harmful effects included: increase in the cost of housing due to higher debt service charged by banks on loans perceived as riskier; reduced maintenance as a result of reduced cash flow; reduction in perceived values of property; deterioration and abandonment of property occur; and the economic stability and housing market of an area was negatively impacted.[13] Therefore, banks were using different underwriting criteria for those loans perceived as risky and areas suffering from disinvestment were perceived as less valuable and less profitable.

Disinvestment and the impacts of redlining emerged as a national issue in the late 1960s and into the 1970s, and, according to reports conducted throughout the country, the problem of race discrimination in lending practices continued into the 1990s.

Redlining

Redlining is a practice by lenders in which loans are rejected regardless of the borrower's credit, character, property condition, and the amount of deposits from the community in which the bank serves.[14] A considerable amount of importance was assigned to the type of neighborhood from which the loan application originated. The result has been a divergence in lending practices between inner city communities and the suburbs. Redlining prevented bankers from

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11 Brimmer & Company, Inc., *Risk vs. Discrimination In The Expansion of Urban Mortgage Lending,* (Chicago: United States League of Savings Associations, 1977), 2.

12 Robert Schafer and Helen F. Ladd, *Discrimination in Mortgage Lending,* (Cambridge: MIT Press, 1981), 2.

13 Urban Consortium, *Disinvestment in Urban Neighborhoods,* 1.

14 Ibid., 3.

becoming familiar with lending in minority communities, thereby precluding any possibility of establishing relationships with minority customers. The lack of relationships allowed the perception of risk to perpetuate throughout many years.

In Boston, two studies recently released indicate that discrimination in mortgage lending continues to occur in black communities. The study, issued by the Federal Reserve Bank of Boston, demonstrates a 24% gap in mortgage lending in black and white neighborhoods.[15] The study, done by the Boston Redevelopment Authority, illustrates an overall ratio in Boston of 2.9:1 during 1981-1987 (applies to one-to four-family mortgage home loans).[16] Bank of Boston wrote 2.1 mortgages in white neighborhoods for every mortgage issued in minority areas. Shawmuts' ratio was 12:1; Baybanks' ratio was 11.7:1; and Bank of New Englands' ratio was 2.6:1.[17] Generally, it was found in the Federal Reserve study that "more mortgages were originated relative to the housing stock in predominantly white neighborhoods than in predominantly black neighborhoods in Boston.."[18]

Redlining and other forms of discrimination in lending have contributed to the continued decline of inner city communities, mainly minority communities. Without access to adequate and affordable financing, these communities will continue to decline.

The data available to study mortgage lending practices was limited to home mortgage loans. While it is important to distinguish loans to developers from the related problem of loans to individuals for mortgages, both are inextricably linked and, according to several

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15 S. Syre, *The Boston Herald,* December 21, 1989, 44.
16 Ibid., 44.
17 Ibid., 41.
18 Katherine L. Bradbury, Karl E. Case and Constance R. Dunham, "Geographic Patterns of Mortgage Lending in Boston, 1982-1987", (Boston: Federal Reserve Bank of Boston, 1989), 13.

lenders in Boston banks, similar criteria are used in the process of evaluating both types of loans.

In Chapter four, case studies of five loan transactions, issued to developers in Boston neighborhoods, are presented. The criteria used to evaluate the loans include; property value, borrowers' net worth and collateral, borrower's ability to repay the loan, and factors of risk--financial, credit, construction, and marketing. These criteria are also used to underwrite home mortgage loans. Moreover, the success of the development loans often relies directly on the availability of mortgage financing.

1.2 BANKING HISTORY

The decline of the center cities can be attributed, in part,to the lending patterns of commercial banking institutions. In the 1950s, most banks only lent to blacks if the property to purchase was located in a black neighborhood.[19] In addition, the National Association of Home Builders (NAHB) implemented separate but equal housing for blacks. These examples indicate that racial discrimination in lending and building practices contributed to the segregation of blacks and whites. However, in 1962, the federal government adopted the policy of preventing discrimination in federally assisted housing. In 1968, under the Fair Housing Act, this policy was extended to cover conventionally financed housing as well.[20] However, for the most part, these policies were not enforced by the government entities responsible for their supervision.[21]

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19 Robert Schafer, "Discrimination in Housing Prices and Mortgage Lending" in *Joint Center for Urban Studies Working Papers No. 55-62,* (Cambridge: Joint Center for Urban Studies of the Massachusetts Institute of Technology and Harvard University, 1979), Working Paper No. 59, p.5.

20 Ibid., 5.

21 Ibid., 6.

During the 1960s and 1970s, banks focused their lending on suburban borrowers, including single-family home mortgages and loans on suburban office buildings, shopping centers and apartment buildings.[22] As urban decline continued, white flight to the suburbs occurred, and housing and businesses deteriorated, banks shied away from the "higher-risk" communities of inner cities. For the purpose of this study, a higher-risk area is defined as an inner-city neighborhood, suffering from disinvestment, where property values are perceived as lower due to location. Lending institutions have been accused of "redlining" certain neighborhoods and therefore have prevented households and businesses from obtaining the necessary financing to prevent the decline of the quality of life. "...lending institutions do not provide mortgages in certain neighborhoods even though the demand exists. As a result, quality of life declines in these neighborhoods...disclosure of lending patterns and regulation of lending criteria and branching activities are necessary to prevent private sector disinvestment in older central-city neighborhoods."[23]

As described by a Boston bank official, the history of banking has taken many different turns. The 1960s can be characterized as a confrontational period when the banks did not feel an obligation invest in inner-city neighborhoods, therefore much of their deposits were invested in the growing suburban areas. The 1970s marked the beginning of communication between the banks and its communities. Banks realized their obligation to serve the needs of their depositors. The 1980s created an environment of partnerships: private, public and non-profits. But by early 1980, when deregulation occurred in banks, an atmosphere of competition for profitable accounts and allowing banks to invest deposits in higher-yield, high risk ventures was created.

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22 Brimmer & Company, Inc., *Risk vs. Discrimination In The Expansion of Urban Mortgage Lending,* 1.

23 Schafer, "Discrimination in Housing Prices and Mortgage Lending", 3.

There was a shift in bank lending patterns away from inner-city communities which paralleled the decline of the urban core. The overall result was increased difficulty in the reinvestment of capital in certain urban neighborhoods by virtue of the lack of affordable available financing in these neighborhoods.

2.0 PROBLEM DEFINITION

Banks play an important role in whether or not a neighborhood thrives or declines. Without available and affordable financing, neighborhoods decline.[24] Lending practices of commercial banks have been held partially responsible for the lack of affordable financing in certain Boston neighborhoods. This chapter describes several factors which contributed to the lack of financing in urban communities. Each factor creates barriers to available and affordable financing for home mortgage and development loans in urban neighborhoods. Deregulation shifted the emphasis of banking to profitability at the expense of lower-income customers; The S&L crisis increased regulatory controls which eliminated the flexibility needed to process non-traditional loans; bank branch closings and the lack of automatic teller machines (ATM) in lower-income areas decreased accessibility to financing for this population; the strict requirements imposed by the secondary-mortgage market made it difficult for lower-income population to qualify for home loans; and the credit crunch continues to make financing for any type of real estate deal very difficult to obtain.

Deregulation

Prior to 1980, banks were tightly regulated. Loan interest rates were regulated by either the Federal Reserve Bank or the state usury laws. Since interest rates were set, there was no price competition. The Financial De-Control Act of 1980 effectively deregulated interest rates. This has changed the banking environment into one of competition resulting in increased emphasis on profit.[25]

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24 Charles Finn, "Mortgage Lending in Boston's Neighborhoods 1981-1987, A Study of Bank Credit and Boston's Housing", (Minnesota: Hubert H. Humphrey Institute of Public Affairs, University of Minnesota, 1989), i.

25 Massachusetts Community Action Program, Directors Association, Inc., "Letter Regarding the Analysis and Recommendations Regarding Basic Banking Services", (Boston: Massachusetts Community Action Program, 1989), 2.

Deregulation shifted the emphasis of banking to high profitability, often excluding lower-income areas from loan services. "...since 1980, we have witnessed a banking industry that has moved from a tightly regulated profitable industry, serving the broad needs of their communities, to one of substantial competition, resulting in an increased emphasis on high profit operations, at the expense of low profit services, needed by our clients."[26] In effect, deregulation contributed to the lack of financing available in certain communities by virtue of the perceived lack of profitability potential.

The increased competition among banks discouraged small accounts by imposing fees. Banks competed for the larger accounts and avoided these smaller, presumed less-profitable accounts. As a result of increased competition, many of the smaller, less powerful banks failed to compete with the bigger banks and were forced to eventually merge with the bigger banks. This put a great deal of power in the hands of very few banks. "'While the deregulation was designed to increase competition, the merger trend has the long term opposite effect. Fewer larger banks are less likely to serve the small niches of the marketplace that are less profitable (i.e. low income customers)."[27] This has created a difficult environment in which to obtain loans for home mortgages and development loans for affordable housing and commercial projects in inner-city neighborhoods.

S & L Crisis

Under deregulation, banks competed for the biggest, most profitable accounts. During the 1980s FDIC-insured deposits grew. Banks and S&Ls used depositors money to invest in over-priced real estate deals, high-yield, high-risk junk bonds and they backed ill-advised

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26 Ibid., 2.
27 Ibid., 2.

projects in inferior locations.[28] "When the real estate market was really hot, some banks tended to disregard their underwriting policies. Then as the market cooled they also failed to update their policies with tighter standards to reflect the deteriorating conditions. The result of these combined errors was a lot of bad loans."[29]

During this time there were lots of flips and other 'get-rich-quick' ventures characterized by poor documentation. Due to the entrepreneurial spirit of lending during the early 1980s, banks were more concerned about the bottom line than the safety and soundness of the loans. By the late 1980s many of these loans went bad and the examiners from FSLIC came in to review the prudency of real estate lending. Thus, by 1989 and 1990, the environment shifted to one of regulatory control.

The southwestern part of the country, Texas in particular, experienced a 'bottoming-out' of its real estate market, to a much greater extent, in the mid 1980s. As a result, bank examiners and regulators have come out in full force to minimize the experience in the northeast. This too has contributed to the lack of financing due to the scrutiny with which examiners are evaluating real estate loans. According to Congressman Joseph Kennedy of Massachusetts, the banks in the Northeast have been treated more harshly. In 1986, Texas was in much worse shape than New England is now, however, regulators were not as tough on Texas banks.[30] The rigor with which regulators are looking at bank loans is discouraging lenders to issue any further credit.[31]

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28 Patricia Chisholm, "The S&L Crisis", *Maclean's,* June 18,1990, 36.
29 *Banker & Tradesman,* June 13, 1990, 38.
30 Testimony of Congressman Joseph P. Kennedy, II, "Hearing on Credit Crunch", (Washington: United States Senate Committee on Banking, Housing, and Urban Affairs, June 21, 1990), 13.
31 Ibid., 10.

Deregulation has created some concern for the future of lending in inner-city communities. In July 1990, Massachusetts passed the interstate banking law which allows banks from outside of the state to acquire Massachusetts banks. Many believe this has increased the potential for new ownership of banks which will affect banks' responsiveness to community needs in terms of credit because the out of state bank may not be familiar with the specific needs of certain neighborhoods in Boston and may be conducting business long-distance.[32]

Bank Branch Closings

The actions taken by banks to avoid the 'low-income niches of the marketplace' included closing less profitable branches, most typically located in inner-city, urban core communities. "Half of the bank branches in Mattapan, Roxbury, the Newmarket area and North Dorchester have closed in the last 10 years-- a time of unprecedented expansion in the banking industry. Other Whiter neighborhoods held even. East Boston, West Roxbury and Hyde Park gained branches over the last 10 years."[33]

According to Mary O'Hara of Massachusetts Urban Reinvestment Advisory Group (MURAG) in her statement at one of a series of forums held to encourage communication between banks and their communities, there are several issues of concern regarding bank branch closings in Boston.[34] First, many of the closings have occurred in low-income neighborhoods. Second, there have been many branch openings in the suburbs, particularly in shopping centers and malls. Third, branches have been significantly

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32 The Office of the Comptroller of the Currency, *Community Development Finance: Tools and Techniques for National Banks,* (Washington: The Office of the Comptroller of the Currency's Customer and Industry Affairs Division, 1989), 7.

33 *The Boston Globe,* January 15, 1990, A21&A22.

34 "Summary of Forum" held on July 13, 1989.

downgraded in low-income areas.[35] According to Dr. Toye Brown of Freedom House, as of July 1989 despite a huge market in Roxbury of 100,000 people, there were only three banking centers in Roxbury: Dudley Station, Uphams Corner, and Grove Hall.[36] Out of this forum several areas of concern repeatedly came up including:

- few residents of minority areas have any bank relationships;
- too few bank branches and ATMs are located in these same areas, therefore, residents are forced to use check-cashing services which charge a great deal of fees for their services and preclude any chance of establishing bank relationships; and
- market focuses on bigger depositors generating greater profits to the bank.

"...Where once banks wanted branches and deposits but not loans, now they want the loans without the branches and deposits."[37] However, some banks, including Shawmut, Bank of Boston, First American, and Neworld, have remained in lower-income minority neighborhoods. A decrease in bank branches in lower-income areas creates difficulty for the community to establish relationships with bankers in order to increase accessibility to bank loans.

Automatic Teller Machines (ATMs)

Fewer ATMs have been opened in lower-income areas. ATMs generally provide customers with free use of machines and other bank-related services. "Only six 24-hour ATMs have been installed in all four minority neighborhoods: Bank of Boston owns four of

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35 "Assessing Boston's Community Bank Services and Products", 2.
36 Ibid., 2.
37 *The Boston Globe,* January 15, 1989, A21.

them."[38] Instead of bank branches and ATMs, check-cashing stores have opened within minority areas. However, check-cashing stores do not take deposits and customers cannot establish and build bank relationships for future bank loans. In addition, there is a large fee charged for check-cashing services, which is generally provided at little cost at a bank branch. Therefore, lower-income minority people living in inner-city urban core areas are being denied access to affordable capital.

Secondary-mortgage market

Although the scope of this thesis is limited to underwriting criteria, similar patterns of discrimination have been observed in relation to financial markets, such as the secondary-mortgage market. For example, according to Karen Kollias of American Security Bank, secondary markets require higher DCR and LTV ratios, which lenders must meet if they intend to sell the loans to either the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac).[39] If a borrower's loan application does not meet the guidelines of the secondary-mortgage market, such as Fannie Mae and Freddie Mac, many banks will automatically reject the application. "The experience of the Commonwealth's Mortgage Review Boards-...-suggests nonconformance with secondary-market requirements is the single leading cause of suspect-loan denials."[40]

Both Fannie Mae and Freddie Mac requirements place significant constraints on a commercial bank's flexibility in its underwriting criteria. The secondary-mortgage market prevents substitution of criteria from occurring, due to the strict guidelines, and therefore precludes non-traditional loans from the secondary market.

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38 Ibid., A21.
39 Kollias, "Community Development Lending: Cutting Edge for Good Business", 20.
40 *The Boston Globe,* January 15, 1989, A22.

Credit Crunch

The credit crunch, or lack of financing, currently occurring throughout parts of the U.S., is making real estate financing very difficult to obtain. As a result, financing for inner-city development, historically perceived as risky, may become even harder to obtain.

There is an on-going debate as to whether or not there is a credit crunch occurring in certain parts of the country, particularly New England. Certain politicians, including Congressman Kennedy and Senator Kerry of Massachusetts, argue that there is indeed a credit crunch in New England. John DiBella, President of Cenvest, Inc. in Hartford, CT, agues that "...the federal regulators have been responsible for restricting the majority--up to 80%-of commercial credit extended to New England companies."[41] On the other hand, Robert Clarke of the Office of the Comptroller of the Currency (OCC) and Alan Greenspan of the Federal Reserve Board (Fed), insist there is not a credit crunch, but rather a tightening of standards in certain areas due to economic factors.[42]

Part of the argument in New England centers around the regulators' unprecedented rigor in examining banks and whether or not this has contributed significantly to the lack of financing. Congressman Joseph Kennedy states that regulators are extraordinarily tough on New England banks and quotes industry experts in predicting that the rigor is inducing a credit crunch in New England.[43] In addition, regulators are reclassifying loans as non-performing even though the borrower may be current on his/her debt service payments. This

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41 *Banker & Tradesman,* June 27, 1990, 4.

42 Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, (Washington: Committee on Banking, Housing, and Urban Affairs, United States Senate, June 21, 1990), 1.

43 Testimony of Congressman Joseph P. Kennedy, II, "Hearing on Credit Crunch", 12.

intimidates banks from issuing real estate loans altogether.[44] This, in effect, restricts availability of financing.

According to Mark Waltch, a financial advisor to several nationwide developers and financial institutions, commercial banks are currently looking for ways to make real estate loans risk-free. In an effort to mitigate risk, banks will either loan money to people with enough capital to cover the amount of the loan or take a lot of collateral, in addition to the real estate. For example, a bank in Canada was approached by a national developer from the United States, for a construction loan for a project in the U.S.. The bank required the developer to deposit an amount equal to the loan into an account in their bank. Another national development firm approached a bank for a construction loan for the rehabilitation of a building in Boston. The bank required an amount equal to 25% of the loan amount, or $75,000,000, to be personally guaranteed. In addition, the bank wanted to see 40% of the space pre-leased with signed leases prior to issuing the construction loan. A large Texas bank was recently ordered by regulators to reduce its loan portfolio in real estate loans from 44% to 8%.[45]

This indicates that further real estate loans may be largely issued to only those who do not need the loan. This essentially precludes loans to non-profits with zero net worth and loans in inner-city communities perceived as high risk whose real estate is not considered sufficient collateral by a bank.[46]

It is important to note that the credit crunch is not only the fault of the regulators, but also of an existing economic slowdown in the northeast which has been spurred on by a decline in the real estate market.[47] According to Joseph Kennedy, real estate is depreciating

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44 Ibid., 13.
45 Personal interview with Mark J Waltch; July 9, 1990.
46 Personal interview with bank official; June 19, 1990, Boston.
47 Testimony of Congressman Joseph P. Kennedy, II, "Hearing on Credit Crunch", 10.

25% in the northeast. Real estate is market-driven and it is argued that in the 1990s the demand no longer exists as it did during the boom years.[48]

2.1 EFFORTS TO CHANGE LENDING PRACTICES

As urban decline spread throughout the Snowbelt cities, including Boston, the commercial banks avoided investing in these areas due in part to perceived higher risk. Lending institutions were considered contributors to the declining quality of life in older, central-city communities.[49] As a result of continued disinvestment in central cities into the early 1970s, many states, including Massachusetts, required banks to disclose mortgage lending information by census tract or zip code.[50] In 1975, Congress enacted the Home Mortgage Disclosure Act (HMDA). HMDA is legislation requiring the disclosure of mortgage lending activity nationwide.

In 1977, the Community Reinvestment Act (CRA) was enacted in response to redlining, requiring federal agencies to supervise financial institutions to encourage them to help to meet the credit needs of the communities where they are chartered while continuing to meet the safe and sound requirements of mortgage lending.[51] The CRA, however, failed to preserve bank branches and banking services in lower-income minority areas of Boston. Concern among members of minority communities and the Massachusetts Bankers Association (MBA) have continued. In July, 1990, changes to the CRA rating system went into effect. These changes were in response to recent amendments to the CRA occasioned by the passage of FIRREA.[52]

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48 Testimony of Senator John Kerry, "Hearing on Credit Crunch", (Washington: United States Senate Committee on Banking, Housing, and Urban Affairs, June 21, 1990), 18.
49 Schafer and Ladd, *Discrimination in Mortgage Lending,* 2.
50 Schafer, "Discrimination in Housing Prices and Mortgage Lending", 3.
51 Ibid., 3.
52 American Bankers Association, "Notes from American Bankers Association Conference", (Washington: American Bankers Association, June, 1990).

Revisions to the CRA requires an institution to publicly disclose its CRA rating and requires Federal regulatory agencies to provide written evaluation of an institutions CRA performance. A new four-tiered descriptive rating system replaced the old five-tiered numerical rating system.[53]

FIRREA

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was enacted by Congress in response to the thrift problem and the general problems of the banking industry, particularly relating to real estate lending activity. FIRREA was created to generally reduce risk and increase financial prudency, specifically regarding housing production loans and other real estate-related transactions.[54] FIRREA imposes very strict standards in terms of lending, which, according to the NAHB, will have dramatic unintended consequences on real estate lending and homebuilding.[55]

FIRREA has had consequences for banks as well as thrifts. "FIRREA has particularly altered the propensity of many banks and thrifts to extend funds for the acquisition, development, and construction (ADC) of residential and other real estate-related properties."[56] The provisions of the legislation include stricter capital requirements, increased single-borrower limitations, and the disallowance of equity investments by thrifts in residential development deals.[57]

While FIRREA applies directly to thrifts, it has far-reaching effects on commercial banks by creating "an unfavorable environment where

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53 Ibid.
54 Barbara T. Alexander, "Will 1990 Signal the End of a Demand-Driven Housing Market?", (New York: Salomon Brothers, January 20, 1990), 4.
55 Ibid., 4.
56 Salomon Brothers Publication, (New York: Salomon Brothers, January, 1990), 3.
57 Ibid., 3.

regulators are wary of real estate lending, affects both thrifts and banks."[58] According to the NAHB, commercial banks cannot pick up the slack from the thrifts in terms of lending and are tightening their own underwriting criteria due to OCC warnings about the dangers of real estate lending.[59] This bodes ill for construction and development loans in the near future.

According to the Salomon Brothers study, the standards set by FIRREA will become the minimum standards applied to all regulated institutions. In other words, regulators will scrutinize real estate loans issued by commercial banks using the same rules and regulations they are currently applying to thrifts. A recent survey by NAHB found that FIRREA legislation is contributing to a lack of financing that is forcing many developers to decrease or stop operations.[60]

City Initiatives

The city of Boston has demonstrated a strong commitment to revitalizing the inner city neighborhoods by creating programs to encourage both the public and private sectors to reinvest in Boston's urban neighborhoods. The programs created have targeted certain areas which have suffered from disinvestment. These programs have encouraged both capital reinvestment and development of affordable housing and commercial properties.

Mayor Raymond Flynn came into office in 1983 as a strong advocate of implementing public policy on a city-wide basis to benefit Boston's neighborhoods. With the assistance of Stephen Coyle,

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58 National Association of Homebuilders, "Investment Sheet on the Financing of Acquisition, Development and Construction Loans", (Washington: National Association of Homebuilders, February 6, 1990), 5.
59 Ibid., 4.
60 Ibid., 1.

director of the Boston Redevelopment Authority (BRA), Flynn began to change the direction of Boston's public policy. The first program put into effect was the linkage fund program. By July of 1985, Flynn released draft guidelines for the revised program. He increased the linkage payments to $6 per square foot, $1 of which would go to a job training program and the remainder to affordable housing development in the city. Later, parcel to parcel linkage was executed to leverage city ownership of land to foster development in the city neighborhoods.[61] These programs were designed to leverage private money and continue to enhance lending opportunities in certain neighborhoods of Boston.

The Safe Neighborhoods Program is part of the city's response to some of the recent activities of youth gangs and violence which contributed to the lack of bank investment in certain urban neighborhoods. Business leaders, community leaders and city officials worked cooperatively to put forth a series of proposals to create housing and job opportunities in Boston's neighborhoods.[62] This indicates an effort to combine the expertise and resources of the private and public sectors to share the responsibility for revitalizing Boston's urban neighborhoods.

Another city agency committed to encouraging reinvestment in Boston's neighborhoods is the Public Facilities Department (PFD). In the 1980s, PFD, formerly the Neighborhood Development and Employment Agency (NDEA), focused its policies on commercial development in targeted areas of the city. The areas were chosen based upon the lack of investment and the high rates of crime and vacancies. The areas selected were urban Boston neighborhoods throughout Dorchester and Roxbury. Due to the limited resources of NDEA, it worked with local banks to invest in these targeted areas.

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61 Telephone interview with Ralph Nemolo, Public Information Officer, Boston Redevelopment Authority; July 9, 1990, Boston.

62 Ibid.

However, many local banks would not invest due to perceived risk and lower values associated with these areas.

In an effort to encourage lending in these areas, the Neighborhood Community Development Bank (NCDB) was established. The NCDB set up a program that encouraged bankers, with whom the city had contracts, to lend to small businesses. The small businesses found it difficult to obtain traditional financing without this program because they were generally less sophisticated, not highly capitalized and located in disinvested areas of the city. Through NCDB, the city provided the funding that allowed the bank to write down the interest rate for the borrowers. The objective of this program and others implemented by NDEA/PFD was to encourage banks to invest in areas of the city by providing tools to increase the perceived safety and soundness of the loans.[63]

In 1985 NDEA was folded into PFD, with many of its policies and programs remaining intact. While PFD continued to create programs designed to encourage banks to lend in Boston's urban neighborhoods, it also created an array of programs which did direct lending without local banks. This change in program was a result of the increasing difficulty in getting banks to invest in certain projects. For example, PFD's LEND program provides flexible loan or grant terms for any type of development. PFD leverages outside resources, and provides gap financing to the borrower. The BUILD program provides funding for large development projects. Block grant money is used to issue short-term loans. As the money is repaid, it goes into a revolving loan fund to be reissued to another project.[64]

Project 747 is an effort to turn vacant city-owned land into affordable housing. Most of the PFD-sponsored projects within the last three years have been done via Project 747. PFD is currently

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63 Telephone interview with Esther Schlorholtz, Assistant Director of Finance, Public Facilities Department; July 11, 1990, Boston.

64 Ibid.

focusing its efforts on both affordable housing and economic development in some of the tougher areas of Boston where the market is at its worst. These areas tend to have a higher minority population and are suffering from disinvestment. " I know bankers do not understand what we are up to or...the agenda we have...From the public perspective, it was most efficient to provide less subsidy money and let the banks take the risks, but therein lies the problem--the banks would not take the risks...and during the last three years we have had a difficult time."[65]

More recently, in the late 1980s and 1990, as a result of two studies issued in Boston to study mortgage lending patterns in inner-city neighborhoods, there has been increased effort to create programs to encourage lending in urban communities. The Massachusetts Bankers Association (MBA), created in the 1980s to represent Massachusetts' banks, in an effort to enhance lending opportunities to the lower-income population, currently asked its members to create mortgage programs with favorable financing rates and terms and to participate in bank-sponsored affordable housing development and small business organizations.[66] In January, 1990, MBA proposed a five year, $1 billion Community Investment Plan (CIP) designed to provide mortgages for affordable housing and economic development, increase the number of bank branches and extend banking services to minority areas. CIP is an effort to involve both the public and private sectors in reinvesting in lower-income, minority areas.[67]

There have been many initiatives from grass roots organizations. For example, in 1989 the Community Investment Coalition (CIC) was formed as a coalition of community organizations. CIC proposed that banks open new branches and ATMs in lower-income neighborhoods

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65 Ibid.

66 Finn, *Mortgage Lending in Boston's Neighborhoods 1981-1987, A Study of Bank Credit and Boston's Housing,* 48.

67 Carras Associates, "Initiatives, Development Finance", (Boston: Carras Associates, Summer, 1990), 1&3.

and offer affordable checking and savings accounts and check cashing services to low-income customers.[68]

The Minority Developers Association (MDA) is a significant player in shaping many of the city initiatives. MDA has offered workshops to the community on mortgage lending and initiated education for minority owners and key managers. MDA has been very involved in recent efforts to increase communication between the banking industry and the minority communities regarding credit availability and banking services.

Some Boston banks have developed and implemented mortgage loan programs for low- and moderate-income borrowers utilizing flexible underwriting criteria, reduced application fees and reduced closing costs.[69] Other banks have agreed to pool resources into loan consortia. For example, the Housing Investment Corporation (HIC) was established and will be funded by a consortium of Boston-based banks. The plan includes $100 million revolving line of credit from which it will issue construction loans for community development lending to for-profit and non-profits, ten new bank branches and twenty ATMs in minority neighborhoods, and $10 million revolving fund for small business loans. While the plan is statewide, half of the funds are targeted to Roxbury, Mattapan, and North Dorchester. There will be no direct lending by banks. All funds will flow through HIC.[70]

The initiatives demonstrated by the city of Boston and some Boston-based banks indicate a strong commitment to join public and private resources in order to end a long history of disinvestment in Boston's urban neighborhoods.

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68 Finn, *Mortgage Lending in Boston's Neighborhoods 1981-1987, A Study of Bank Credit and Boston's Housing,* 45.
69 *The Boston Globe,* September 9, 1989, 49.
70 Personal interview with bank official; June 19, 1990, Boston.

3.0 COMMERCIAL LENDING

This chapter presents a framework to use in analyzing the case studies. The structure of commercial banks and how they are regulated is outlined. A framework is provided in order to understand traditional and non-traditional underwriting criteria as presented by Karen Kollias in her working paper entitled, "Community Development Lending: Cutting Edge for Good Business." Kollias is a nationally recognized leader in community development lending. The chapter presents a summary of interviews with Boston bankers conducted to understand the actual lending practices used in Boston. Finally, a brief overview of the process model in the recently published handbook entitled, "Principles and Practices of Community Development Lending" by C.P. Line and C.E. Riesenberg is provided.

Commercial banks are in the business of making money by lending and accumulating funds. "A commercial bank is a private financial institution organized to accumulate funds primarily through time and demand deposits and to make these funds available to finance the nation's commerce and industry."[71] Banks make money by charging higher interest on money loaned out than on money accepted as deposits. Many banks charge fees for services such as checking accounts and credit cards.[72]

Regulation

Commercial banks are regulated by any of several organizations. Nationally-chartered banks are regulated by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board

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71 Marshall W. Dennis, *Fundamentals of Mortgage Lending,* (Reston: Reston Publishing Company, Inc., 1978), 42.

72 Laura Duenes, *Community Development Lending: Case Studies of Commercial Bank Lending Programs,* (Cambridge: Massachusetts Institute of Technology, 1989), 20.

(Fed). State-chartered banks are regulated by the Federal Deposit Insurance Corporation (FDIC). S&Ls are regulated by the Office of Thrift Supervision (OTS), formerly the Federal Home Loan Bank Board (FHLBB). Bank holding companies are regulated by the Fed.[73] These federal and state regulatory agencies were established to maintain and promote "a system of bank supervision and regulation..."[74]

Bank examinations vary from regulator to regulator. Generally, the Fed conducts examinations every 18 months, FDIC and OTS every 24 months, and OCC is on a lottery system. Regulators get involved in bank operations in several ways. First, commercial banks must be federally- or state-chartered by a regulating agency. Prior to issuing a charter, the OCC and most state banking agencies require the bank "to meet the convenience and needs of their communities."[75] Second, regulators promote the safety and soundness of loans by requiring banks to utilize "sound management principles and comply with the law."[76] Also, regulators encourage banks to "satisfy customers and community needs while remaining efficient competitors in the financial service markets."[77] Through guidelines enforced by the regulators, maximum loan terms and maximum aggregate lending as a percentage of total deposits or capital are regulated. In addition, regulators review banks in terms of compliance with "legal requirements such as those involving privacy, discrimination, and CRA."[78] Compliance is also reviewed in terms of rules and regulations including "...loan amounts supported by acceptable appraisals, prudent underwriting to minimize offset risk, and loan portfolios that are diverse and not overly concentrated with one project type."[79] Third, regulators approve or deny

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73 Telephone interview with representative of the Federal Reserve Bank of Boston; July 9, 1990, Boston.

74 The Office of the Comptroller of the Currency, *Community Development Finance: Tools and Techniques for National Banks,* 1.

75 Ibid., 3.

76 Ibid., 1.

77 Ibid., 1.

78 Telephone interview with bank examiner; July 9, 1990, Boston.

79 Kollias, "Community Development Lending: Cutting Edge for Good Business", 16.

applications for relocation, expansion, branching, new charters, merging, and other changes in the banks' structure. "Regulators grant and deny such requests on the basis of the bank's history, financial solvency, and ability to meet its charter obligations."[80]

According to a bank examiner at the Fed in Boston, examiners are now reviewing bank loans for prudency. However, examiners have always conducted periodic examinations of banks and their loans. According to the Fed, they have always examined banks in terms of (i) assessment of quality of assets; (ii) condition of banks regarding safety and soundness and compliance of loans; (iii) review of bank balance sheet including loan review. Generally, red flags go up on real estate loans which have an LTV of100% because this ratio is considered unsafe. Also, larger, troubled loans classified or reclassified as non-performing loans are scrutinized carefully.[81]

Key bank officials have stated that within the last two years, regulators have changed the criteria used to evaluate the safety and soundness of loans. According to Congressman Joseph Kennedy, regulators have not changed the rules, but they are more rigorous in their application.[82] Regulators from the Fed indicated that their criteria have not changed, but their methods have changed due to the current state of the economy. During a real estate boom period, banks have more flexibility in their underwriting because the market can withstand more flexibility. Whereas, during a downturn, there is less flexibility due to greater risk. Regulators have reacted to this. Examiners are still looking at loans in terms of the numbers, primarily the DCR, LTV, appraisal values, and the like.[83]

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80 Duenes, *Community Development Lending: Case Studies of Commercial Bank Lending Programs,* 21.

81 Personal interview with bank examiner, Federal Reserve Bank of Boston; June 29, 1990, Boston.

82 Testimony of Congressman Joseph P. Kennedy, II, "Hearing on Credit Crunch", 12.

83 Personal interview with bank examiner, Federal Reserve Bank of Boston; June 29, 1990, Boston.

Regulators are scrutinizing banks within the framework of particular standards per the Fed, OCC, and FDIC. At the same time, per revised CRA regulations (effective 7/1/90) which are stricter in terms of disclosure, regulators are telling banks to be creative in order to fulfill their CRA obligations.[84] According to bank lenders, the mixed message creates an atmosphere of confusion for the banks, interpreted by the banks to mean "stop lending." Added to the confusion is the lack of communication of information among different regulatory agencies and the bankers. According to many of the Boston banks, the regulators have had the greatest impact on the banking industry to date. Industry experts anticipate that banks will stop making real estate loans altogether. According to Federal Reserve analysts, lending in first quarter 1990 is less than fourth quarter 1989 and is predicted to continue to decline.[85]

The fact that banks did not invest in inner cities due to the perceived higher risk through the 1980s and into the 1990s is quite ironic considering the history of bank investment post-deregulation. Deregulation created an investment atmosphere best described as high risk. Financial institutions, particularly the S&Ls, invested a great deal of their depositors money into high risk ventures which eventually turned bad, creating many of the problems banks are facing in the 1990s. The result of these high-risk ventures has been increased regulation. As the issue of redlining and disinvestment has resurfaced via new studies issued in Boston and other parts of the country, increased pressure on the banks to meet their obligations to serve the financial needs of their communities has been the result. It is now more difficult to substantiate underwriting criteria necessary to make non-traditional type loans in disinvested areas. Therefore, the disinvested communities have been hurt by the S&L debacle.

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84 Personal interview with bank official; June 19, 1990, Boston.
85 Testimony of Congressman Joseph P. Kennedy, II, "Hearing on Credit Crunch", 8.

3.1 COMMERCIAL BANK UNDERWRITING

The interviews with industry representatives confirm that Kollias' framework is applicable to understanding lending in Boston. Comparing the framework with the results of the interviews reveals both similarities and subtle differences. Bankers were asked what factors they consider in evaluating a loan; not all responded initially with the underwriting criteria they used, although most broached the subject without being prompted by the interviewer. Six of the lenders and two of the bankers in workouts commented on underwriting criteria for traditional lending.

It is significant to note that very few of the bankers speak of lending and underwriting criteria without mentioning the current market conditions. Many make distinctions between lending today and lending three to five years ago. Generally, lenders attribute differences in lending activity over time to changes in the real estate market, competition created by deregulation and pressures imposed by regulators.

Lenders' assessment of the current market and the impacts on lending practices provides a lens into the future of commercial lending. Generally, lenders indicated that lending in the 1990s will become much more difficult to do. When asked about loans currently being evaluated, one lender stated, "...Nothing even comes in the door. Well, one came in the door, but there was a cash flow shortfall. It was real tight as to whether they could make the interest payments. The collateral was non-existent and the organization did not have the wherewithal to do the project."[86] The lender commented that the bank was committed to providing advice, time, and inkind services to the applicant, but the market was very bad for issuing loans.[87]

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86 Telephone interview with bank official; July 6, 1990, Boston.
87 Ibid.

Another lender explained that lenders are returning to basics in terms of underwriting. "A lot of banks have suffered losses of capital and are not looking to lose anymore... there are more problem assets now and banks are more reluctant to stretch [their underwriting criteria]."[88] The lender concluded the interview with an evaluation of the impact competition has had on his bank's lending practices:[89]

> Lending is not scientific. You can't make a checklist. We see how competition drove us away from what has been historically considered prudent lending. We wanted to increase our earnings by 20% like everybody else and nobody was smart enough to turn that down.

3.2 TRADITIONAL LENDING AND LENDER INTERVIEWS

Kollias describes four basic criteria that banks use to underwrite projects: credit of the borrower, character of the borrower, collateral value of the project, and cash flow from the project.

Credit of the Borrower

"Credit analysis of the borrower enables the bank to determine the borrower's previous and current borrowing history."[90] People with extensive positive borrowing history are good; people with no borrowing history are considered more risky since there is no experience to evaluate. In fact, people with no borrowing history are not much better from the bank's perspective than borrowers with poor credit histories.[91]

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88 Ibid.
89 Ibid.
90 Kollias, "Community Development Lending: Cutting Edge for Good Business", 18.
91 Ibid., 18 & 19.

Only three of the bankers specifically mentioned credit of the borrower, both current and previous credit, as part of the set of criteria used to evaluate a loan. Two of the three are lenders at smaller banks. One lender said that he considers "...the sophistication of the borrower,..whether the borrower had good credit, and the borrower's relationship with the bank."[92] One possible explanation for this is that clear credit may be one of the most basic and least subjective requirements that a bank considers during its loan review process. A former lender made the following comment on underwriting criteria:[93]

> ...in retail lending you looked at income, credit, and downpayment...in lending for owner-occupied residential, you looked at job stability, clear credit, percent of income to loan, and size of downpayment...

He continued to say that the structure of commercial loans is more of an art. "Five years ago, we all thought it was easy. Inflation was helping us out...by the time a loan went bad we had more equity."[94] Now banks require more equity and better market research, but "...lenders never compromise on credit."[95]

Character of the Borrower

Kollias describes character of the borrower as follows:[96]

> Character, which can be a subjective evaluation measure, is often determined by [how substantial the borrower's financial statements are and how well a lender may know the borrower]. The ability and amount of what someone may borrow is often

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92 Telephone interview with bank official; June 28, 1990, Boston.
93 Telephone interview with bank official; July 6, 1990, Boston.
94 Ibid.
95 Ibid.
96 Kollias, "Community Development Lending: Cutting Edge for Good Business", 19.

> determined by his or her net worth, and the liquidity of that net worth.

Of eight lenders interviewed, only two spoke in literal terms about the character of the borrower. Nevertheless, all of the lenders addressed the subject indirectly through related issues pertaining to borrower's character, such as guarantees, equity, deposits, and income. Many of the lenders listed guarantees and equity among items required in the loan review.

One lender from a large bank explained that when considering a borrower, she looks at their personal financial statements and operating history of their other development projects. She uses a network of attorneys, accountants, and brokers to collect information necessary to complete the review of the borrower. She characterizes this type of work as "investigative" and noted that some borrowers were known names and some were unknown. A written report to loan committee on the borrower often includes information about who the borrower is, the borrower's legal entity, the guarantor, and the guarantor's relationship with the borrower.[97]

The other lenders made distinctions about what was done several years ago as compared to what is done today. One lender said:[98]

> Several years ago 100% loans were made...[the banks] weren't looking at the developer's financials...they were just looking at the project's financials...now, [the bank] is requiring equity and full disclosure of all the developer's properties.

Another lender implied that there were cases when loans were made to developers without financial resources. "Three years ago if you could write a decent proposal you could get a loan. Banks bought off

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97 Telephone interview with bank official; July 2, 1990, Boston.
98 Telephone interview with bank official; July 6, 1990, Boston.

on outrageous rent projections, minimum debt coverage service, and developers without financial resources."[99]

Another lender noted that the information from the borrower must include cash flows for each of the guarantor's properties. This allows the bank to consider not only the strength of the guarantor and the project, but other factors as well. For example, the lender requires cash equity of 20-25% from a strong developer, but will most likely not accept land value as equity.[100] In addition, a lender could not fund a project if the cash flow was not there at the time of underwriting, even if the borrower had a strong relationship with the bank and projections for future cash flow.[101]

Collateral Value of the Project

The collateral value of the project is the third criterion used by banks:[102]

> A bank usually lends no more than 80% of the project's appraised value as a general rule of thumb consistent with regulations. If the project, or its location, is considered risky, this percentage may decrease accordingly.

All eight lenders considered the collateral value of the project in their loan review process. Lenders look for loans secured by the real estate, personal guarantees, and LTVs of 75-80%.[103] One lender said the preferred LTV is 65-70%, with exceptions up to 80%.[104]

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99 Telephone interview with bank official; June 29, 1990, Boston.
100 Telephone interview with bank official; July 5, 1990, Boston.
101 Ibid.
102 Kollias, "Community Development Lending: Cutting Edge for Good Business", 19 & 20.
103 Telephone interview with bank official; June 28, 1990, Boston.
104 Ibid.

Many bankers commented on the increased importance of outside appraisals in determining the value of the collateral. One lender described a report submitted to loan committee which included an explanation of the type and terms of the loan, the type of real estate product and its collateral value, the location of the property, additional security for the loan, and a summary of the loan indices such as LTV and DCR. The lender said that at one time, she would have found a comfortable capitalization rate (cap rate) based on level of risk. However, as the market deteriorated, the use of appraisals replaced cap rates.[105]

Another lender noted that while the underwriting standards had not changed, the implementation or adherence to them had changed. For example, several years ago a lender could have avoided having an appraisal completed simply by concluding "...if you cap the NOI at X%, the loan will be at 70% [LTV]...or 50% of value, so we do not need an appraisal.."[106] However, now the appraisal is an absolute.[107]

Cash Flow from the Project

All lenders mentioned cash flow from the project as a critical element in the loan evaluation. Lenders typically require an existing operating statement or cash flow projections. The lender is concerned with the project's net operating income (NOI) in order to calculate what is available to repay the loan. NOI is project revenue less operating expenses. NOI is divided by the debt service payment in order to calculate the DCR. The DCR varies depending on the value of the property, the financial strength of the customer, and the level of risk perceived by the lender.[108] According to Kollias, "A common example [of a debt coverage ratio] is1.15...For projects perceived as

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105 Telephone interview with bank official; July 2, 1990, Boston.
106 Telephone interview with bank official; July 5, 1990, Boston.
107 Ibid.
108 Kollias, "Community Development Lending: Cutting Edge for Good Business", 20.

risky, it is likely that a bank may require a minimum of 1.25 debt service coverage ratio."[109] DCRs mentioned by the lenders interviewed generally ranged from 1.15 to 1.25. A lender who had used a DCR of 1.15 several years ago stated that the DCR would be higher today.[110]

Portfolio Issues

Issues pertaining to the bank's loan portfolios surfaced consistently during many of the interviews. Several of the comments included below are indicative of how the banks' considerations on the portfolio level impact the placement of any one loan within their portfolio. Generally, there is increased pressure from state and federal regulators to diversify bank portfolios which contain a predominance of real estate loans.

One lender from a large institution stated that one recently revised written bank policy deals with the portfolio distribution of real estate assets including land, industrial, commercial and residential uses. There is now a cap on the amount of real estate loans in the bank's portfolio.[111]

Another lender echoed a similar point when she explained her bank's new portfolio limits and lending parameters created to diversify the portfolio and reduce the bank's exposure:[112]

> We've been in real estate for [decades]... and will go forward if something mitigates the risks... we are not going to take the risks anymore... we didn't get paid enough for it... the point is to eliminate the risks.

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109 Ibid., 20.
110 Telephone interview with bank official; July 6, 1990, Boston.
111 Telephone interview with bank official; July 5, 1990, Boston.
112 Telephone interview with bank official; July 6, 1990, Boston.

On the other hand, a lender from a smaller bank indicated that she has maintained her bank's lending limits in underwriting loans. The bank's lending policy continues to limit the amount of a mortgage loan to no more than 15% of capital, no more than 30% of capital may go to one borrower, and total land loans may not exceed 20%. The lender stated that the bank's portfolio contained a mix among home mortgage loans, commercial real estate loans, and commercial business loans. However, the bank is currently scaling back its lending activity.[113]

The changes in bank policies and attitudes led one lender to reflect on the events that contributed to the changes in commercial lending. The condominium market slumped first and the office market was not far behind because of the continued overbuilding. "Right now lending is not on the top of anyone's list."[114] The bank has made a decision to continue real estate lending, but the real estate portfolio is too large.[115]

3.3 NON-TRADITIONAL LENDING AND LENDER INTERVIEWS

According to Kollias, when the four underwriting criteria, described in the section on traditional lending, are put together, many non-traditional, community development projects do not receive bank financing. Kollias explains further:[116]

> Aside from the obvious disadvantages that potential borrowers face with respect to credit history and character, many community development projects generate marginal cash flow, and the overall value of the project may not be substantial. Nonprofit and minority developers who do not have substantial net worth may have a difficult time putting equity into the

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113 Telephone interview with bank official; July 9, 1990, Boston
114 Telephone interview with bank official; July 5, 1990, Boston.
115 Ibid.
116 Kollias, "Community Development Lending: Cutting Edge for Good Business", 20.

project (i.e., 20% of the project costs if total project costs roughly equals its appraised value and the bank lends 80% of the project costs) and guaranteeing loan repayments if the debt service coverage ratio is thin.

Kollias maintains that community development lending is good business, "When structured correctly, a community development loan can be as profitable as any other loan."[117] For this reason, she advocates a non-traditional approach to community development lending which begins with a commitment by the bank "to distinguish between good and bad community development investments."[118]

Non-Traditional Underwriting Criteria

Kollias uses her own experience at American Security Bank (ASB) to illustrate how underwriting criteria can be adjusted to determine the economic feasibility of non-traditional loans. When the Community Development Group was formed at ASB, they reviewed the bank's traditional underwriting criteria and decided to emphasize cash flow from the project and collateral value of the project. "The group's approach to 'project-based underwriting' includes: treating subordinate sources of finance as project equity; calculating debt service coverage only for the bank's debt, and accepting other sources, reserves or guarantees as additional coverage if cash flow tight..."[119] While the group emphasizes project cash flow and collateral, they do not ignore credit history and character of the borrower. The group does not turn applicants away because they do not have substantial financials, but looks for "...a description of technical capacity and previous or current experience..."[120]

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117 Ibid., 27.
118 Ibid., 26.
119 Ibid., 37.
120 Ibid., 39.

Kollias stresses the importance of the borrower's track record. Her approach to non-traditional lending implicitly requires the lender to understand a broader spectrum of risks. "The estimation of risk, and how to deal with it, is part of the bank's underwriting process."[121] A process model included in a handbook entitled, "Principles and Practices of Community Development Lending", written by C.P. Line and C.E. Riesenberg, attempts to identify and respond to specific risks in non-traditional lending.

The Process Model

The objective of C.P. Line and C.E. Riesenberg's work in "Principles and Practices of Community Development Lending", is to promote the theory and practice of non-traditional lending.[122] Their work is written from a banker's perspective and provides an analytical process which draws from the traditional underwriting process used by many private financial institutions.[123] The authors maintain that, "the creative community investment process is really no different from the normal credit review process, except for the addition of a loop that identifies the financial gap often present in community loans and then seeks public enhancement as a co-investment."[124]

The handbook presents a five step model used to perform a detailed risk analysis. Conceptually, the model is useful because it separates 'perceived risk' into components and offers specific techniques to mitigate each component.

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121 Ibid., 18.
122 C.P. Line and C.E. Riesenberg, "Principles and Practices of Community Development Lending: A Five Step Investment Model to Strengthen Bank Community Development Programs", 4-1.
123 Ibid., 4-1.
124 Ibid., 4-1.

The first step of the model presents an institutional underwriting process which includes an analysis of the following: "...appraisals, credit worthiness of leases, local market characteristics, character of the developer, and the financial management capability of community resources."[125] The handbook instructs the lender to project future cash flows and to determine the 'financial gaps' in a project by using ratio analyses such as, DCR, LTV, and cash flow rate.[126]

In step 2, the 'financial gaps' identified in step 1 are "...grouped into four principle types, each of which has distinctive characteristics and thus unique remedies."[127] The four groups of financial gaps are: high risk, low return, low profitability, and interest rate risk. High risk is broken down into credit risk, collateral risk, and maturity risk, all of which affect the likelihood that the principle is recaptured. Low return is characterized by an inadequate return to investors. Low profitability is characterized by an inadequate return to the lender. Interest rate risk affects the likelihood that interest rates will fluctuate over the term of the loan resulting in loss of interest income to the lender.[128]

Once the financial gaps are identified in step 2, step 3 of the model guides the lender through matching the gaps to the correct financial solutions or credit enhancement technique options.[129] In step 4, the model aides the lender in the selection of appropriate assistance techniques.[130] Finally, in step 5 community assistance techniques are matched to specific community assistance programs.[131]

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125 Ibid., 5-2.
126 Ibid., 5-1.
127 Ibid., 6-1.
128 Ibid., 6-7.
129 Ibid., 7-2.
130 Ibid., 8-2.
131 Ibid., 9-2 to 9-6.

Interviews on Non-Traditional Lending

The interviews with six lenders and two former lenders demonstrated how Boston community development lending differs from Kollias's framework. It appears that although these particular Boston bankers take a conservative approach, they utilize some of the available non-traditional mechanisms in order to participate in community development lending. Several lenders expressed concern about the future of community development lending within the context of the current regulatory environment and real estate lending market. They also spoke about problems in community development lending in general.

Kollias stated that her group at ASB emphasizes project cash flow and collateral value. Furthermore, credit history and character of the borrower are not ignored, but are considered in light of the borrower's track record and/or expertise. In contrast to this approach, a community affairs banker of a large bank said of a community development loan that "...if it did not fit into the traditional lending criteria, it would not have been made."[132]

However, a lender at the same bank described the evaluation process of community development loans as placing greater emphasis on cash flow, rather than collateral value. The lender described the focus on cash flow as follows:[133]

> ...inner city deals require funding sources... it is an alphabet soup of players... we look to see if we think that the property will lease at proforma levels, or whether the units will sell within the right time frame... we look at the track record of the entity and whether they have the capacity to do this particular project... we don't assume any appreciation, depreciation, or vacancy rate... we look at appraisals carefully as if things were going to be stable... and translate them into conservative cap

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132 Telephone interview with bank consultant; June 26, 1990, Boston.
133 Telephone interview with bank official; July 11, 1990, Boston.

> rates or discount rates. We try to determine if the deal makes economic sense... We try to make it workable with all players at whatever the level of debt...

The lender also evaluated the equity committed to the project and the strength of the borrower:[134]

> ...the structure of the deal is key. You generally need as much below market rates as you can get, as much equity, as many grants, deferred loans and subordinate financing as possible. We are asking for more equity these days. We try to look beyond the cash flow of the single project, but it depends on the structure of the entity. You have no recourse in a limited partnership. We look not so much at what their financial fallback is, but what is their capacity and if they are over their heads...and whether they have other projects that are sapping their resources, personnel, or energy. Non-profits don't have deep pockets. In a for-profit, we have a guarantee and its meaningful. For these projects, we want to know about what is going on in all the other properties. Whether the projects are non-profit, for-profit, inner-city, or rural, the policies are no different--we look at all of them the same...

Another lender at a large bank expressed a similar attitude about using non-traditional lending mechanisms within a conventional approach. "Are we conservative? You bet!.. I am a banker... that is the expertise I bring to the table. It doesn't mean I don't care. It means I don't program things to fail from a banker's perspective."[135] In explaining her approach, she commented that bankers had to be comfortable with the numbers. She explained the ways to find comfort in the numbers:[136]

> ...you do not eliminate criteria [in underwriting non-traditional loans] you *substitute* ... and your level of comfort comes from your experience and knowledge about the substitutions you

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134 Ibid.
135 Personal interview with bank official; June 19, 1990, Boston.
136 Ibid.

> make... you have to understand the downside of using government programs as cash equity... you have to understand how they are funded... when they are funded and what the conditions [of funding] are... you have to keep current with the players... you have to have a contact in the government so you know who to call... you can only be an effective advocate if you know what you are advocating.

Examples of "substitutes" include developer expertise and experience, the reputation of the construction manager, a commitment for permanent takeout, credit enhancements, and outside appraisals.[137]

While another lender at a smaller bank communicated a fairly conservative approach to community development lending, she also noted that in cases where the sources and uses did not match, she considered certain city contributions as equity. In her loan evaluation, she looked at construction risk, marketing risk, credit risk, and financial risk.[138]

A lender with experience in issuing loans for affordable housing stated that in evaluating loans, he considers the track record and capacity of the borrower, the financials including a line by line analysis of developer's profit, the pros and cons of using non-union labor, the reasonableness of estimates, and the reputation of the contractor, management company, and development team.[139]

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137 Ibid.
138 Telephone interview with bank official; July 3, 1990, Boston.
139 Telephone interview with bank official; June 29, 1990, Boston.

4.0 CASE STUDIES

This chapter presents case studies of five loan transactions issued by three Boston-based banks between 1986 and 1989. All five case studies provide the bank's perspective, and three of the five provide the developer's perspective as well. All information in the case studies was provided by the banks, developers, and public and quasi-public agencies. The names of the banks, lenders, developers, and projects have been changed due to the proprietary nature of the information.

4.1 ABC BANK

ABC Bank, a state-chartered bank regulated by the FDIC and state agencies, is a small, local bank established in early 1980. Eighty percent of its portfolio is concentrated in real estate, particularly in housing and small business loans in low-income areas. Its target areas of lending included Roxbury, Dorchester and Mattapan.

ABC Bank, a relationship lender, looked to the borrower for a demonstration of strong commitment and spirit. It benefitted from establishing strong relationships within the minority community in which it served. One of its objectives was to commit funds in disinvested areas of Boston.

Its targeted communities, often perceived as higher-risk, have been the victim of unaffordable mortgage terms including higher interest rates and points. Such unfavorable terms, generally offered by private lenders, have made it difficult for customers in these communities to reinvest in their neighborhoods.

ABC Bank's philosophy was described as working closely with its borrowers, often less sophisticated CDCs and other non-profit organizations. There was a need for creativity in order to produce feasible loan packages that met the criteria of loan committee as

well as safety and soundness requirements of the regulators. ABC Bank, therefore, monitored each project carefully. A loan officer, assigned to each proposed loan application, worked closely with the developer to put together a do-able package. One loan officer referred to the close working relationship he maintained with many borrowers throughout the entire development process as a "cradle to grave" relationship.

The underwriting criteria generally used by the bank was fairly traditional, but ABC maintained a great deal of flexibility on the numbers and allowed for public subsidies to be considered as equity. Often the flexibility was substantiated through long-term relationships with borrowers. For example, it looked for a DCR of 1.25 but had gone down to a 1.10, depending on the borrower. Also, a 65-70% LTV was preferred, but depending on the relationship with the developer, it was as high as 80%. In addition, public subsidies had been used by borrowers as leverage for private investment. A loan application with a grant from the City of Boston gave the bank a great deal of comfort. The average loan amount issued by the bank was $300,000 to $800,000.

ABC described being creative as "minimizing your risk, making the project worthwhile, and knowing how to find other resources if needed."[140] Every loan officer should understand the state and federal programs with available funding sources.

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140 Personal interview with bank official; June 28, 1990, Boston.

ABC Bank--Loan #1

Background

Several local Community Development Corporations (CDCs) joined forces in mid 1980 to form an entity called the CDC-Group to produce 84 condominium units of affordable housing. The CDC-Group illustrated a creative collaboration of community-based groups in an effort to develop housing in a disinvested area in Boston. This non-traditional collaboration of CDCs recognized the different levels of capacity of each organization and drew on the expertise and strengths of each to create a strong development team. Each CDC packaged their designated properties financing and marketing.

Property

In 1969-1970, an Infill Housing Program was undertaken by HUD and a private developer to construct 400 units of family housing on vacant sites scattered throughout Boston. Over 100 units in 17 structures were begun, but the project was abandoned before they were finished. In 1986, the abandoned shells were still standing and continued to be an affront to the neighborhoods in which they were located as well as the city. The property consisted of 124,067 square feet of land and 89,508 square feet of interior.

The 17 structures, located in several Boston urban neighborhoods, were packaged as one development project to take advantage of the economies of scale and provided the hope that the project would be completed, thereby adding to the quality of life in the neighborhood.

Improvements

The 17 structures were rehabilitated into 84 condominium units. The buildings were made up of 40-2 bedroom units; 36-3 bedroom

units; and 9-4 bedroom units. Units contained approximately 912-2736 square feet. Amenities within the unit included ample closet space, washer/dryer hook-up, two full bathrooms for the 3-bedroom and 4-bedroom units, ample kitchens and comfortable to ample bedroom sizes. The land and building were donated at no cost to the CDCs.

The Deal--ABC Banks' Perspective (Phases I and II)

The CDC-Group applied to ABC Bank for a revolving construction loan and temporary first mortgage. The sources and uses of financing were as follows:

Sources of Funds:

Cash Equity		
Public Source-1	$	500,000
Public Source-2	$	200,000
Public Source-3	$	21,300
Other Equity Sources		
Land & building from Public Source-1	$	840,000
Building permit waived/City	$	56,642
Public Source-1 Tech assist./Comm Dev.	$	90,000

Total Equity	$	1,707,942
Debt Financing:		
ABC Bank & participants	$	6,262,311
CDFC	$	200,000

TOTAL SOURCES	$	8,170,253
		============

Uses of Funds:

Construction cost	$	5,610,000
Soft cost	$	1,371,193
Total Contingency	$	349,060
Account	$	840,000

TOTAL USES	$	8,170,253
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The proposed participants for construction financing included three banks. ABC bank's portion was approximately $2,000,000 at 10% interest rate for a period of 1.25 years. The LTV was 76.6% based on development costs. Developer's fee of $112,200 or 2% of hard costs was allocated to the CDCs.

Source of Repayment

Repayment of loan was via sale of condominium units. Units were released at 95% of the actual sales price.

a.) The Homeowner Opportunity Program (HOP) in conjunction with ABC bank assisted in 63 units. (8 units in phase I were market-rate).

b.) 21 units were taken out by Boston Housing Authority (BHA) under the 705 program.

Terms of the Takeout

HOP financing provided an assisted interest rate beginning at 5.5% and increasing 1% each of three years until the interest rate floated to 8.5% in nine years. ABC Bank worked in conjunction with MHFA to provide individual take-out loans to qualified homebuyers for both

HOP and conventionally financed mortgages. Resale controls were required to prevent speculation and preserve affordability.

ABC bank worked closely with the CDCs throughout the development process and with the mortgage applicants in order to expedite the closing process.

Developer's Perspective

According to the CDCs involved in the development, the project ended up being split into two phases because of problems with ABC bank. ABC bank was not in a position to provide a construction loan for the entire development and therefore sought a participating bank for construction financing of Phase I.

Phase I was completed in 1989. Phase I consisted of 48 units in total: 20 units were set aside for the BHA to purchase and rent, 20 units were HOP units and 8 were market-rate units. As of July, 1990, Phase I was 80% sold: 20 BHA units sold, 5 market-rate units and 13 HOP units sold.

ABC bank provided the take-out loans for individual buyers. According to the CDCs, CDC staff worked very hard to get applicants through the process because there were many problems getting applicants to qualify. Some of the problems identified by CDC staff included:

1.) The ratios for the secondary market were not realistic. They were paying 35-40% of their income for rent. This surpassed the required 28% to qualify for homeownership.
2.) Many were self-employed and their incomes fluctuated a great deal.

3.) Credit problems were an issue. Applicants did not have any credit or they did not understand the importance of knowing how to clean up their credit history.

CDC staff thought it was the downpayment that prevented many of the applicants from buying, but there were broader issues that were intangible.

The cost of the development was about $100-105,000 per unit, but according to HOP limits, the sales prices were set at $80-85,000 per unit. According to CDC staff, "appraisals came in lower because 1.) HOP deed restrictions limited the return on equity and 2.) preconceived notions about the value of property in Roxbury reduced the values."[141] This helped the affordability of units, but hurt the CDCs. According to the CDCs, the only one who made any money was the bank.

Public Source-1 considered not funding Phase II (36 units) of the development. Linkage funds were becoming tighter and the city was reluctant to commit as much money as it did on Phase I. The CDCs had a commitment for HOP units, but due to the time lag, they will have to reapply. Phase II was uncertain due to financing constraints experienced by the city and the uncertain future of commercial lending.

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141 Telephone interview with CDC staff member; July 9, 1990, Boston.

ABC Bank--Loan #2

Background

A city of Boston agency (agency) won a bid to purchase 16 buildings containing 73 units of low-income housing from HUD. HUD sold the property subject to a 15 year deed restriction which required the owner to rent the units to tenants who qualified under HUD guidelines. It was sold subject to $913,000 of renovations completed within 12 months of the purchase date. The agency applied for construction financing and a letter of credit from ABC bank in 1988. The agency, a public entity which developed, owned, operated, and managed low rent housing in the City of Boston.

Property

The property consisted of 16 buildings, containing 73 residential units plus a vacant parcel of land. The buildings consisted of 100 year-old three and four story masonry row houses. The buildings were assembled approximately 20 years ago for renovation into low cost housing. However, since that time, the buildings had been undermaintained and considerable deferred maintenance occurred.

The properties, located in the an urban neighborhood of Boston, consisted of 9 studios, 20 one bedroom units, 16 two bedroom units, 15 three bedroom units, 7 four bedroom units, and 6 five bedroom units. Sixty-five of the 73 units were, at the time of acquisition, occupied by low-income tenants.

The Deal--ABC Bank's Perspective

The renovations were completed in two phases. In phase one, renovations were completed on 28 occupied units and the eight

unoccupied units were completed 12/31/88. Phase two consisted of the completion of the remaining 37 units in the spring of 1989.

The total development budget for the project was $4,231,500. Sources of funds included the following:

ABC Bank loan-construction/interim first mortgage	$ 2,000,000
City agency equity	$ 2,231,500

TOTAL	$ 4,231,500

The project had a DCR of 1.23 and a LTV of 47%.

ABC bank provided a construction loan for $2,000,000 for 18 months at prime plus 1%. This loan was converted to a permanent loan for three years from the end of the construction loan. The rate on the permanent remained at prime plus 1%. In addition, a Letter of Credit was required by HUD to assure completion of the renovations. A $913,000 letter of credit was provided to HUD during phase one of the rehabilitation of the property. HUD had the right to draw upon the Letter of Credit for three months after the period required to complete the rehabilitation. The Letter of Credit had a maturity of 18 months from closing and the borrower paid prime plus 1%.

ABC Bank--Loan #3

Background

The borrowers were two individuals who operated a for-profit real estate development and property management company conducting business in Roxbury, MA. The individuals obtained a loan from ABC bank to refinance an existing commercial building in Roxbury. The borrowers were long-standing customers of ABC bank, since its inception.

Property

The building was a two-story brick building with office and retail space. It had 6,623 square feet of gross building area with 13 store units leased at the time of loan closing. Tenants included a clothing store, sub shop, record store, Big Brother Association, and a variety of professional offices.

The Deal--ABC Bank's Perspective

The refinancing occurred in late 1980. The developers obtained refinancing in the amount of $550,000 for three years at 13.5% fixed rate. The $550,000 went toward paying off two outstanding loan amounts, one to ABC and one to another Boston bank. $174,403 was cashed-out of the deal and used for working capital and the development of other property.

The individuals were required to personally guarantee the loan amount. In order to ensure that the borrowers kept current on the debt service payments, a late charge was agreed to as part of the loan closing. The mortgage amount represented a loan-to-value of 66%. The debt coverage ratio was 1.05. The borrowers had a well-

developed relationship with ABC bank, "a total banking relationship", on both business and personal accounts.

4.2 XYZ BANK & TRUST COMPANY

XYZ Bank & Trust Company is a state-chartered bank regulated by the state banking commission and the FDIC. Its holding company is regulated by the Fed. Formed in 1960 in a Boston suburb, the bank moved to Boston in the mid 1980s.

By definition, XYZ was a smaller lender. Its territory was local, generally within 50 miles of Boston. The bank focused on what it understood in terms of lending area; philosophy of issuing housing loans based on the lenders' understanding of the area in which their borrowers chose to live. According to an XYZ bank official, "...lenders can understand why people live inside the Route 495 area, but not in western Massachusetts. Therefore, the target area for housing loans is between Boston and Route 495."[142]

XYZ established certain lending limits due in part to the experience of other smaller, state-chartered banks which ran into trouble after issuing loans based on 5 times capital to one loan. At XYZ, no mortgage can be greater than 15% of capital to one loan, or 30% of capital to one borrower. These limits protected XYZ from some of the problems banks are experiencing today.

Loans in excess of $1 million had to be approved first by a bank division head and then loan committee. As a part of the bank approval process, loans were underwritten. The lender considered the type of product, source and amount of equity, development and marketing risk, and financing and credit risk. On average, XYZ loaned at 1 1/2 points over prime on all types of loans.

The bank's portfolio was mixed including home mortgage loans (first mortgages and equity loans), commercial real estate loans and commercial business loans. At one time, during the peak of the

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142 Telephone interview with bank official; July 3 & 6, 1990, Boston.

bank's activity, nearly 20% of its portfolio was made up of CRA loans.

XYZ Bank--Loan #4

Background

Green Estates, a condominium development, was one of the first projects initiated by the Public Facilities Department. The project was also one of the earliest under the State's Homeownership Opportunities Program (HOP) and among the first using Chapter 705 state subsidy program. According to PFD, it was a pathfinder on just about every aspect.

The site, located in a Boston urban neighborhood, was formerly a public building that was demolished about 10 years ago, but was most recently, a vacant lot. A for-profit developer, Properties Developer, was designated in mid 1980 to construct 24 attached townhouse condominium units, made up of three-bedroom units. Modular housing construction was used.

The Deal--XYZ Bank's Perspective

XYZ issued a construction loan for $2.1 million, or 80% of the development costs, in the fall of 1986. The loan term was an adjustable rate equal to prime plus 1 1/2 points for 1 1/2 to 2 years. A twelve month construction term was assumed for modular housing development. The LTV was 80%, based on total costs. Repayment of the loan was tied to individual unit closings.

Equity sources included a $200,000 Neighborhood Development Fund loan from Public Facilities Department (PFD) and $172,500 from Community Development Action Grant (CDAG) for infrastructure and road work. According to the lender, the sources and uses did not match. The bank looked to the property and the developer's personal net worth and liquidity as collateral for the loan. The developer was allowed a profit of $10,000 per unit.

In reviewing this loan application, the lender looked at two things first: 1.) the feasibility of the project in terms of its actual completion and 2.) the commitment from the city. Since it was manufactured housing, the lender looked carefully at the housing manufacturer's ability to perform. Since the lender had done similar construction loan deals with manufactured housing, there was no perceived problem with its viability. The city contributed money in two ways: 1.) equity towards the development deal and 2.) equity to reduce the purchase price for the homebuyer.

The lender also evaluated the risks associated with the project, including construction risk, marketing risk, credit risk, and financial risk. Since the lender had previous experience with modular housing construction, she knew what to expect. Some aspects of the construction went slower than expected. The bank did not disburse any loan funds until the unit was attached to the foundation, so risk was minimized.

According to the lender, marketing proved to be the most difficult. Since the majority of the units were under the HOP and the remainder under MHFA's first time homebuyer program, the lender expected the marketing to be quite easy. However, the lender did not anticipate that the particular area in which the project was located had a stigma due to recent shootings and drug-related crimes.

Credit and financial risk on the project had more to do with the borrower than the project. The lender looked for personal guarantees from the borrower because the development company was just starting out. As a result, there was not an established company behind the borrower and therefore, the trust itself was the property. The bank minimized its risk by taking personal guarantees from the borrower. The lender voiced some concern about the area. "You couldn't do market-rate housing here...drug busts, some rif-raf, it's a

scary area."[143] According to the developer, "you couldn't do market-rate housing because you can't build a comparable house in the area. The cost of construction was prohibitive."[144]

Two out of the three buildings were completed in1987. The third was finished in winter of 1989. All units were sold by summer, 1989. According to the lender, the project was completed late and repayment of the loan was late. According to the general contractor, the project was completed late due "to the relative experience of the contractor."[145]

Developer's Perspective

Properties Developer began it operations in the mid 1980s, in residential development, particularly affordable housing. The target area of their developments were in Roxbury, Dorchester, South End, and Cambridge. In the late 1980s, Properties Developer diversified its operations into retail. Currently with a small full-time staff, Properties Developer has $80 million worth of assets.

Green Estates was one of their first ventures. They worked closely with the neighborhood residents in order to come up with plans that were acceptable. The neighborhood wanted three-bedroom units, eat-in kitchens, washer/dryer hook-ups, and unfinished attics. The developers incorporated these items into the plans.

There was a belief that if you offered a low mortgage rate with less than a $5,000 investment, there would be a lot of people wanting to purchase a home. The area in which Green Estates was located was already a depressed area which normally had problems with crime

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143 Ibid.
144 Telephone interview with project manager; July 30, 1990, Boston
145 Ibid.

and drugs. Due to the attractiveness of the product and the low mortgage rate, it was believed that these barriers could be overcome. Several market studies were produced which showed sufficient incomes and interest to purchase a home by the families already living in the area. Even though there existed a problem with crime and drugs, most families remained in their neighborhood. According to the developer, the biggest marketing problem was the availability of eligible purchasers who could meet the state and city guidelines. The developer was very successful in locating families for the development in light of these constraints.[146]

According to the project manager, things went smoothly with the bank until homebuyers needed take-out loans. It was difficult to get applicants through the process. "There were so many restrictions, income, family size, etc., that it was difficult to get someone qualified."[147] The project manager described walking applicants through the entire process in order to get them qualified. This took a great deal of time.

Due to the delays in construction and sales, the project got caught in the softening of the condominium market of late 1988. The bank began to get scared as the market softened, unit sales slowed, and repayment from unit closings were delayed. The bank eventually got repaid. The developer achieved its intended goal of helping the revitalization of this depressed area.[148]

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146 Ibid.

147 Personal interview with project manager; July 3, 1990, Boston.

148 Telephone interview with project manager; July 30, 1990, Boston.

4.3 TOWNBANK

Townbank is a commercial bank regulated by the OCC. By definition it is a large bank with its main office is located in downtown Boston.

Townbank's Department of Government and Community Affairs was responsible for relationships with government agencies, community development groups, and private developers pursuing projects with a high level of community reinvestment significance. Townbank was active in the Neighborhood Development Program, a city program started in the late 1970s, designed to help small businesses and commercial properties in neighborhoods by lowering the cost of borrowing to encourage revitalization by lowering interest rates. Townbank was a leading bank in the program during the mid 1980s.

The Neighborhood Development Program drew upon banks' credit judgement and resources to offer borrowers 2/3 to 3/4 of the base rate. The city limited the banks' rate exposure by depositing money into the bank on which no interest was required. The amount deposited was calculated to lower the interest rate to make it affordable to the project (7-8%).[149] The compensating balance deposited by the city yielded no interest to the city and therefore was compensation to the bank and served as a vehicle for the bank to pass on the savings to the borrower. The city's deposit was not in any way a guarantee or collateral for the bank's loan to the borrower.[150]

Townbank had special resources to deal with non-traditional type loans. While all loans were expected to meet the traditional underwriting criteria of the bank, through the Department of

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149 Telephone interview with former director of NDEA; June 26, 1990, Boston.
150 Telephone interview with bank official; June 26, 1990, Boston.

Community Affairs, some non-traditional loans were reviewed with greater emphasis on social purpose and city commitment.

TOWNBANK--Loan #5

Background

The Blueskies Building, a rehabilitation of a building into artist lofts and commercial space, came to Townbank through a non-profit developer (CDC) in cooperation with and assisted by PFD. The project was considered, by the bank, to be an non-traditional loan with a multiplicity of funding sources. Included in the funding sources was a first mortgage from Townbank, a second from Community Development Finance Corporation, and a third from PFD.

Property

In mid 1980, the project involved the purchase, rehabilitation and mixed-use development of the Blueskies Building in a Boston urban neighborhood. The 20,000 square foot, four-story building was left vacant, except for a 2,000 square foot Major Drug Store. The remaining 18,000 square feet of commercial space was vacant for many years.

The non-profit developer (CDC) and Major Corporation proposed a partnership to develop the project. Under the agreement, Major Drug Store leased the new, 4,400 square foot first floor for 15 years. The three upper floors were converted to ten condominiums: 8 artist workshop/lofts, one rental, and one office. The 11,460 square feet of upper floor space was redeveloped and leased for five years with an option to purchase.

The Deal--Townbank's Perspective

The deal was brought to Townbank by many socially-minded lenders and investors, including PFD, CDFC, the non-profit developer, and other city agencies. The bank found comfort in the deal due, in part,

to the players' experience and the commitment demonstrated by all involved. The people involved were " people who would work together if a crisis arose...who were comfortable enough to subordinate their interests..."[151] There was public interest and popular support for the project. "The numbers alone for this deal were not enough; you have to show commitment and hope that in a crisis situation, people would work to solve the problem."[152]

Once introduced to the bank through the Community Affairs Department, the loan followed the traditional route through the bank. The real estate division gave the loan the "normal" review, including the evaluation of the following:

1.) Value of the property, using the market and income approach of valuation.
2.) Projected cash flow, including the carrying costs for all debt and operating costs. (Debt coverage ratio of 1.2 was sought, but this loan had a DCR of 1.1).
3.) Capacity of the developer.
4.) Capacity, experience and soundness of documentation of architects, engineers, and contractors.
5.) Evaluation of real estate in terms of amount of risk and exposure of the bank.

This particular loan was of interest to Townbank due to the commitment of funding from the city and CDFC as well as the fact that Major Drug Store signed a long-term lease for the entire first floor of the building. Leases for the artists lofts were not in hand at the time of loan closing, however, the bank was comfortable with the amount of interest demonstrated once the artist market had been identified.

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151 Ibid.
152 Ibid.

The loan went to loan committee for final approval. Once approved, a letter of commitment was sent to the borrower with conditions of the loan transaction. The bank's main condition was that all other funding sources be available and ready to go before loan closing.

Sources of Funds:

Townbank	$	200,000
Equity-L.P.	$	175,000
CDFC	$	50,000
City Block Grant	$	200,000
Non-Profit	$	50,000

TOTAL SOURCES	$	675,000

Developer's Perspective

The non-profit developer (CDC) was incorporated in the late 1970s through the efforts of three neighborhood civic associations in a Boston urban neighborhood. The CDC was formed to "address the problems of economic disinvestment, deterioration and abandonment of housing stock, the drastic decline in the area's only commercial center, a general lack of public works and high unemployment levels."[153]

In order to get financing for the Blueskies building, the non-profit developer had to appeal to the Department of Community Affairs at Townbank. According to a member of the CDC staff, no other bank would consider their loan package. Townbank was the only bank that let them in the door and stuck with them throughout the process.[154] Other financial institutions did not want to lend any money. The

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153 "Summary", Development Package Submitted to Bank by CDC, 1983, 13.
154 Telephone interview with director of CDC; June 27, 1990, Boston.

developer even approached banks with CRA problems to offer them the opportunity to remedy some of the problems, but they said "no thanks". Townbank told the developer to secure other sources of funding first. The developer went to the city and CDFC.

According to the director of the CDC, the bank wanted "the first born son".[155] The bank wanted Major Drug Store to sign a 25 year lease and made this a condition of the loan. The bank also wanted artists to commit to a 5-year lease for the loft space. The developer felt this was an absurd request given that the artists generally had no money.[156] In addition, the developer had to raise $175,000 by syndicating the historical tax credits. It took a year to put the whole thing together.

According to CDC staff, there was a lot of talk about DCRs, but "basically it boiled down to what Townbank was willing to lend. They finally said they would not go over $200,000. CDFC chipped in and PFD came up with the balance...Whatever it needed to be to make the project affordable...There was no equity, no coverage...We were just trying to break even. It was an uneconomic project in the first place."[157] According to the director of the CDC at the time of the deal, traditional underwriting criteria was not used in this deal. "I don't think you could check off a half dozen [underwriting criteria] that were standard."[158]

Recently, CRA issues are more and more evident in the newspapers, but it is not making it any easier to obtain financing. The CDC is currently trying to get end loans for the artist lofts and finding it difficult because, afterall, these are the mortgages the banks have to hold in their portfolios.[159]

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155 Ibid.
156 Ibid.
157 Ibid.
158 Telephone interview with former director of CDC; July 2, 1990, Boston.
159 Telephone interview with director of CDC; June 27, 1990, Boston.

5.0 ANALYSIS

This chapter provides an analysis of the case studies within the context of bank underwriting criteria provided in chapter three. It also provides conclusions regarding whether or not the five loan transactions described in chapter four would be processed and approved in the 1990s. Finally, chapter five closes with a discussion of how the Boston experience is generalizable to other cities throughout the country.

Non-traditional lending differs from traditional lending in several ways. The way in which non-traditional loans are underwritten is the focus of this analysis. As defined earlier, non-traditional loans are defined as loans issued in disinvested urban areas with underwriting criteria used which strays from traditional underwriting criteria.

While traditional lending places emphasis on profit, non-traditional lending places priority on the benefits to the community. As seen in the case studies, the numbers alone do not make these types of deals work, there needs to be a strong commitment from the city, as well as creative ways to structure the loan transactions. The non-traditional process adds a step to the 'normal' credit review in order to identify and direct public enhancement to fill the financial gaps and provide comfort to the lender.[160] For the purpose of this study, level of comfort is defined as the mitigation of risk to a point where the lender is comfortable enough with the loan package that its approval by loan committee is likely. In these cases, it is used in reference to the private lender sharing the risk with the city.

The five loan transactions were issued on properties located in Boston urban neighborhoods which historically suffered from

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160 C.P. Line and C.E. Riesenberg, *Principles and Practices of Community Development Lending: A Five Step Investment Model to Strengthen Bank Community Development Programs,* 4-1.

disinvestment. Each bank made a decision to invest capital into these neighborhoods, placing greater emphasis on social responsibility than profit. While ABC bank had an on-going commitment to lending in these neighborhoods and long established relationships with many of its borrowers, XYZ and Townbank had less history of lending in these neighborhoods. All five loans involved a tremendous time commitment by both the lender and the developer due to the complexity of the deal structure and, as well as, in some cases, the inexperience with non-traditional type loans on the part of the developer, the lender, or both.

Many of the Boston lenders interviewed in this study indicated that the underwriting criteria used did not differ depending on whether the loan was considered traditional or non-traditional. In fact, many lenders interviewed stated that they do not substitute criteria in order to process non-traditional loans. If a loan package does not meet standard requirements in terms of DCR, LTV, equity, and personal guarantees, the loan is not approved. In particular, the three banks who provided information for the case studies made similar statements. However, as evidenced in all five case studies presented, each lender exercised flexibility in substituting traditional underwriting criteria for non-traditional underwriting criteria to process these loans. Examples of flexible underwriting criteria include calculations of public sources of financing as equity or income, reduced DCR requirements in exchange for personal guarantees, or approval of loans despite little or no equity from the borrower.

Larger banks, such as Townbank, expressed more conservatism in approaching non-traditional loans than smaller banks, such as ABC and XYZ banks. However, in the final analysis, the larger bank and the smaller banks underwrote non-traditional loans exercising a similar amount of flexibility in substituting criteria. In all cases, for example, the lenders acknowledged and accepted public sources of financing as either equity or project income. Sources included grants, subsidies, linkage payments, and loans from public and

quasi-public entities. As demonstrated in four of the five loan transactions, these sources increased the feasibility of the projects and provided a level of comfort to the lender. The strong financial commitment provided by the city, in case studies #1, 2, 4 and 5, minimized the risk for the banks.

As described in chapter three, lenders look for minimum requirements in terms of the numbers on traditional loans. Generally, lenders look for no greater than an 80% LTV based on the project's appraised value. This percentage may decrease if a project is considered risky. The equity required varies depending upon the amount of the LTV, but equity percentage should make up the difference. The DCR also varies depending on the project and the borrower. DCRs range from 1.15 to 1.25 depending on the amount of risk associated with the projects' potential cash flow.[161]

The loan transactions described in the case studies illustrated the flexibility with which non-traditional loans are underwritten. For example, in case study #3, the loan was underwritten with a DCR of 1.05. In exchange for the lower DCR, the developer was required to personally guarantee the loan amount. Case study #5 had an LTV of 29.6% and a DCR of 1.1. In this case, the borrower put up a large portion of equity, so the banks' risk was minimized. While the other case studies had ratios which fell within the traditional range, developers were required to personally guarantee the loan amounts, or there was enough financial support from the city to provide a level of comfort necessary for the lender to process the loans.

Three of the five developers came to the lending institutions with either little or no equity or commercial credit history. For example, in case study #4, the development deal was one of the first by the developer and therefore the development company had little track record and no commercial credit history. As a result, the lender

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161 Kollias, "Community Development Lending: Cutting Edge for Good Business", 20.

required personal guarantees and public sources of funding in place at the time of loan closing. Case studies #1 and 2 illustrated loans to non-profit developers with little or no equity. In each case, the lender found comfort in the public commitment demonstrated by the city and the commitment of the non-profit developer.

The dilemma for the commercial lender in a situation where the borrower does not have 'deep pockets' and there is no history of commercial credit is the lack of recourse should the loan go into default. In the case of non-traditional loans, as seen in the case studies, the properties were located in areas of perceived higher risk and lower values. Therefore, banks did not necessarily want the property should default occur. However, as demonstrated in the case studies, with strong financial commitment from the city, lenders perceived their risk to be shared and therefore gained comfort in lending.

According to bank lenders in Boston, it is unlikely that the five loans issued between 1986 and 1989 would be issued in the 1990s. One reason is that as a result of FIRREA, the minimum standards for underwriting loans has become much stricter. Lenders are losing some of the flexibility needed to underwrite non-traditional loans. Due to the stricter standards and the rigor in which examiners are reviewing bank loans, many lending institutions will not be in a position to issue real estate loans. Furthermore, many banks are being ordered to reduce the percentage of real estate loans in their overall portfolio.

Another reason for the decline in non-traditional lending centers around diminishing public funding sources. As presented in the case studies, a central element in all of the loan transactions was the financial commitment of the city. Each lender indicated that the city commitment essentially made the deals viable from the bank's perspective. As these sources of funding disappear, these types of loans will be increasingly more difficult to process.

The city of Boston has demonstrated a strong commitment to the reinvestment of capital into certain urban neighborhoods by providing equity and project income to individual development projects. This is illustrated in the case studies and through city initiatives aimed at enhancing lending opportunities in areas of Boston suffering from disinvestment. In addition, community organizations have played critical roles advocating and implementing many of the programs designed to combine public and private resources. The end result has been the formation of several local, city, and state groups and forums organized to address the lack of affordable and available financing in inner-city neighborhoods of Boston.

While some banks have responded to the credit needs of inner-city neighborhoods by creating programs providing construction loans for community development projects, banks must consider longer term financing in these neighborhoods. Banks must maintain a presence to further promote increased quality of life by making long-term commitments to the economic stability of these areas by establishing permanent loans, home mortgage loans, and a physical presence that fosters relationships. It is important to note that the Fed must come forward and take a stronger role in setting requirements for lending which would encourage banks to issue longer-term loans.

There has been increasing pressure from CRA and through city of Boston initiatives to issue non-traditional types of loans in disinvested areas of Boston. At the same time, however, increased regulation has created an environment where lenders are apprehensive about issuing real estate loans, particularly loans perceived as risky. The affects of the two opposing pressures are yet unknown. However, the Fed is purported to begin meeting with CRA regulators in order to mitigate any potential negative impacts of these pressures. Several bank officials in Boston indicated that Boston banks will not fulfill their CRA obligation unless they can meet the safety and soundness and compliance regulations. On the

other hand, some lenders and industry experts stated that the only real estate loans that will be issued in Boston in the future will be a result of legislative pressure and city initiatives. This dilemma must be resolved if the problems of inner cities are to be addressed.

In order to replicate the Boston experience, four key components must exist. First, there must be a strong commitment of the city, the banking industry, and local developers to reinvest in inner-city neighborhoods which have historically suffered from disinvestment. Second, there must be a combination of public and private funding sources available to provide revolving loan pools for construction and permanent financing of affordable housing and commercial properties as well as home mortgage loans in inner-city neighborhoods. Third, community organizations must work in partnership with the city and banking industry in order to implement city initiatives similar to those in Boston. Fourth, banks must be willing to underwrite non-traditional loans with flexibility including reduced interest rates, reduced closing costs and fees, and alternative sources of equity sources.

There does not exist an art or a science to underwriting loans. Although models for underwriting criteria exist, projects need to be analyzed and packaged individually. Each brings to the table a unique set of factors that must be addressed. Lenders evaluate loan packages based on different assessments of risk, bank policies and willingness to be flexible. Therefore, much of underwriting is subjective. The flexibility used in substituting underwriting criteria in order to process loans which foremost benefit the quality of life and economic stability and potential growth of inner-city communities is an essential element in any reinvestment strategy proposed by the Fed, CRA regulators, and other key actors.

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