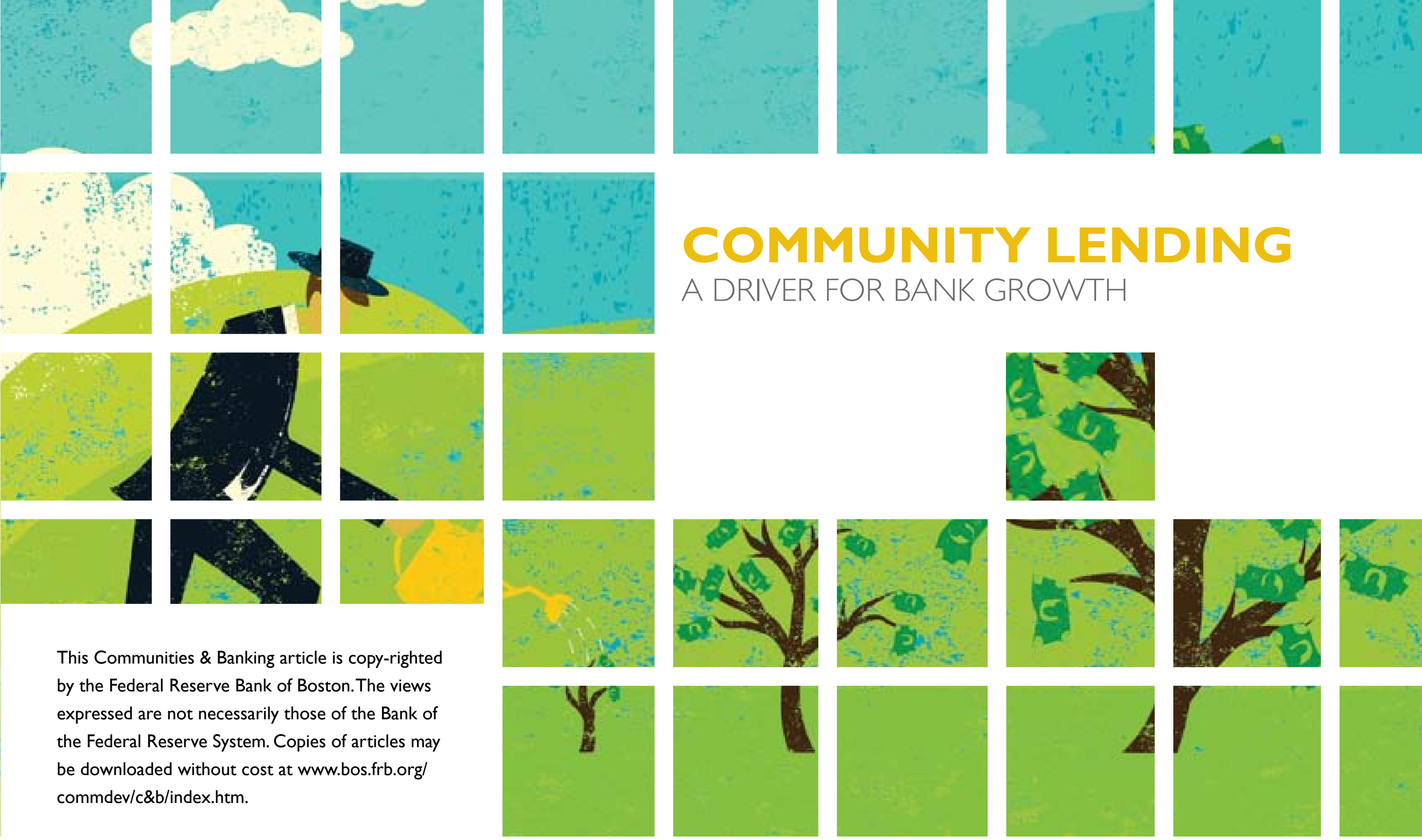

COMMUNITY LENDING

A DRIVER FOR BANK GROWTH

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FINANCIAL INSTITUTIONS THAT MAKE LOANS FOR AFFORDABLE HOUSING AND ECONOMIC DEVELOPMENT DO GOOD FOR THEIR COMMUNITIES. THEY ALSO DO WELL FOR THEMSELVES.

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On first impression, one might assume that loans for affordable housing or for building a health center in a low-income community are more risky than other types of commercial real estate loans. The borrower may be a cash-poor nonprofit organization. The end users—tenants, job-program participants, patients—may face economic pressures. The collateral value may be low compared with total project cost.

Nevertheless, such community development loans can be safe, sound, and profitable. Done right, they can help a financial institution grow.

That has been the experience of Boston Private Bank & Trust Company, a $6 billion bank, where commercial lending has grown more than 10 percent annually in each of the past five years. Community development loans were critical to that growth. Boston Private Bank booked more than $125 million of new CRA-eligible commercial loans in the past two years (as of December 31, 2011). That equates to more than 15 percent of all commercial loans originated within a commercial portfolio that grew $285 million net over the same period.

Since 1987, the bank has made successful community development loans to build affordable housing, health centers, grocery stores, charter schools, and youth-training facilities and to finance small businesses and low- and moderate-income first-time homebuyers. Loans have been made primarily in the bank's initial home, Boston, but now also in its California and Pacific Northwest regional offices. The bank has learned that partnering with the stable and mature community investment industry can pay off.

The Underwriting

As with any credit, a key component of credit quality for community investment loans is the borrower and the borrower's ability to pay back a loan.

Borrowers for affordable housing and economic development tend to be nonprofit organizations without a lot of free cash. They do not have liquid assets at a level that would merit an "A" rating in a traditional credit analysis. Fortunately, other attributes of these borrowers mitigate the risk.

First, community development borrowers pass with flying colors character tests like a commitment to paying back a loan. As neighborhood institutions, they are committed to long-term, stable investment for lower-income people and their communities. They are determined to build projects that last—from the quality of construction to the stability of the financing. Banks know these borrowers will work tirelessly to ensure the success of their projects.

In Chelsea, Massachusetts, for example, a historically low-income urban community just north of Boston, a collaboration between community-based nonprofit Chelsea Neighborhood Developers and a for-profit developer (on a city- and statesupported conversion of a vacant former mattress factory into residential loft space) was stalled in the 2007 economic downturn. It was the last piece of a neighborhoodwide strategy, and although a more conventional borrower might have abandoned the project, these developers doggedly worked with their mission-driven lenders to invest more equity and to structure a financially feasible loan for Boston Private to underwrite. The resulting project, Atlas Lofts, has succeeded financially beyond expectations and has become the important community building block it was envisioned to be.

Second, many community development borrowers are sophisticated borrowers. Although when they started out decades ago, they may not have had much real estate experience, by now, organizations such as Chelsea Neighborhood Developers, Urban Edge Development Corporation, and Harborlight Community Partners have long and successful track records. They employ experienced professionals who understand the complex and heavily regulated field of community investment. Their projects are well planned, their assumptions are realistic, their loan applications are professional. And these projects are almost invariably as complicated as projects many times their size. In the Chelsea transaction, for example, the developers had to keep a roster of eight financing entities moving in the same direction—not to mention the construction contractor.

Third, community development borrowers collaborate effectively with a wide range of financing partners in addition to banks. These financing partners—host municipalities, state or federal governments, private investors—stand behind the borrowers with significant equity or subordinate debt. It is not uncommon for community investment projects with total development costs of $15 million to support only $5 million to $7 million in first-mortgage debt, with the remainder of the costs paid by subordinate debt or equity. When three-quarters of the project cost is outside the first mortgage, a lender can be quite confident of repayment. Less debt means that appraised values can be lower and that interest payments (and cash flow requirements) will be lower. All in all, less debt makes the loan more likely to be repaid on time.

In the development of the Chelsea project, Boston Private provided a construction loan totaling approximately 43 percent of the total development cost of $15.7 million, in a first-mortgage position that was senior to financing from the state, a regional financing consortium, two mission-driven lenders, an equity investor interested in the state historic tax credits associated with the project, another equity investor interested in the federal historic tax credits, and the for-profit partner who had invested equity directly into the project.

Finally, community development borrowers have already had an extra level of due diligence and project-feasibility analysis because public funding requires it. By the time a first-mortgage application reaches a financial institution, public projects have been analyzed and reanalyzed by experts at government and quasi-government funding agencies. Understandably so: when one in five to 10 projects is being funded, scrutiny is intense.

Many community investment transactions involve significant investment by private, for-profit entities. An investor's return depends on the financial success of the proposed development, frequently over a 15-year period, so the underwriting is suitably rigorous. In the Chelsea transaction, the key investor was Best Buy. More recently Wal-Mart Stores, Google, Apple, and many other well-known companies have invested in these types of projects.

Thus borrowers, with their often limited liquidity and assets, are not the only participants with a significant stake in the success of an affordable housing or economic development project. Although neither the public lenders nor the private investors are usually obligated to step in if a project encounters serious trouble, they do have a strong interest in doing so. They may make significant additional investments when needed, and the lender may restructure the loan. It takes patience on the part of a lender in those rare cases, but the patience is usually rewarded with a feasibly restructured transaction. It's the commitment of all parties to the transactions that makes them work.

How to Get Started

Those four strengths (commitment, sophistication, collaboration, and deep financial analysis) mean that community investment loans can be treated just like any other loan. Government lending and economic development funding make up for lack of liquid assets, and the passion of nonprofit leaders enables them to overcome obstacles. That is why other parts of the lender's underwriting are quite straightforward. A bank should apply the same credit metrics as it would in conventional transactions:

- 75 percent to 80 percent loan-to-value ratio (with reference to the collateral's value as restricted by the various public programs). Although these projects may involve low collateral/cost ratios, the collateral/first mortgage ratio is strong.
- 1.15 times—or better—debt service coverage (the net operating income from the property exceeds the required amount of annual interest and principal payment by at least 15 percent). Less debt makes it possible for low-cash-flow projects to meet this requirement.

Boston Private prices community investment loans just like any other commercial loan. As of this writing, the rate on an affordable housing project would be around 250 basis points over the cost of funds. For a 10-year deal, the rate might be approximately 5.5 percent. Thus community investment can be a valuable business line.

To succeed in lending for affordable housing or other community development activities that involve businesses or service providers in lower-income communities—most often utilizing some sort of public support—you need contacts and enough experience with frequently changing public programs to properly understand the dynamics and the risks. That experience can be earned in different ways.

One alternative might be to make investments or loans into lending or equity funds managed by experienced, mission-driven entities such as the Massachusetts Housing Investment Corporation or Boston Community Capital. Those private, nonprofit entities underwrite community investment transactions and loans or invest the aggregated funds using the same measures of creditworthiness that a bank would use, but without the same formal safety and soundness requirements that regulated banks must meet. A second alternative might be to participate in loans with lending institutions that have more experience.

Over time, lenders who make community investment loans not only will make a contribution to the economic health of their communities but also will garner high-quality new business.

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