Summary of the 15th Annual Financial Innovations Roundtable
March 19-20, 2015
Federal Reserve Board in Washington, D.C.

Over the past fifteen years, the Financial Innovations Roundtable (FIR), located at the Carsey School of Public Policy at the University of New Hampshire and hosted by the Division of Consumer and Community Affairs at the Federal Reserve Board, has worked with a range of community development and other types of financial institutions, government agencies, foundations and trade associations to address and solve problems related to access to capital for low-and moderate-income consumers and communities. The FIR does this by tapping the expertise of thought leaders from the institutional investment, banking, philanthropic, and community development industries.

The 2015 Financial Innovations Roundtable focused on **how innovations in small business lending can be harnessed to better serve small business borrowers and enhance community and economic development.** In the wake of the financial crisis and recession, both online and mission-driven lenders have stepped in to fill some of the gap created by the banking sector's retrenchment from the small business lending market. Some of these institutions are not new – both small and microbusiness CDFI lenders, and the merchant cash advance providers, have been around for more than fifteen years. What are new are their moves to incorporate technology (and particularly online tools) into their business practices. Other institutions – such as Peer-to-Peer (P2P)/marketplace lenders, or unregulated balance sheet lenders – are new disruptors, using technology to bring new investors to the lending marketplace, as well as to dramatically cut costs, and approve and fund loans much faster than banks or microlenders ever have.

As we work to solve the credit crunch that continues to affect our nation's small businesses, it seems there might be opportunities for each of these three types of lenders to learn from, or collaborate with, each other.

What partnerships and initiatives can be undertaken, with whom, and how? The 2015 FIR brought together representatives from banks, community development finance, and small business online lenders to talk about opportunities for collaboration as well as the challenges of scaling up small business lending using technology. (See appendix for participant list.)

Key Objectives:

1. *To understand changes in the small business lending marketplace that affect community development lenders and the small business customers they serve.*

2. *To identify and begin to advance ways for CDFIs and other mission-based lenders to take advantage of and shape technological developments that can improve small business access to credit and encourage growth of the small business lending marketplace.*

DAY 1: SETTING THE STAGE

At the March 19 evening session, **Amanda Roberts** of the **Federal Reserve Board of Governors** and **Michael Swack** of the **Carsey School of Public Policy** welcomed participants to the 16th annual Financial Innovations Roundtable. Donning his faculty hat, Swack began with Muhammed Yunus's controversial assertion that access to credit is a human right. "Yunus said, 'We have a list of human rights, so I was proposing to put a right to credit on that list. If people can make income for themselves, they can take care of many of the rights on that list – health, housing, education, food. Humans are creative and full of potential and energy. Money allows them to express this.' But if access to credit is a human right, then how do we do it better?"

The field of small business has many new technology-driven entrants as well as conventional banks, community development and other mission lenders. The Carsey School's recent industry analysis for the CDFI Fund showed the success of many community development lenders, including their ability to serve the market and manage risk. But the community development lending field is small and many institutions are capital-constrained. The business model of many CDFIs is not sustainable, and many conventional financial institutions don't do small business lending. Therefore, there are many outstanding questions regarding the CDFI field's ability to expand its small business lending activities through technology adoption, including:

- What is the value of online platforms and related technologies to our customers? Simply convenience? Or more?
- What is the value of these platforms to CDFIs and other mission-oriented lenders? More loans? Greater impact? Lower origination costs?
- What are the disadvantages to customers? Lack of underwriting flexibility? Cost?
- What are disadvantages to CDFIs? Too much standardization? Higher losses? Loss of contact with borrower?
- Where do banks fit into this?
- How can we advance ways for mission-based lenders (including CDFIs) to shape technological advancements that improve access and increase lending?

Finally, Swack thanked FIR's sponsors (Goldman Sachs 10,000 Small Businesses, the Heron Foundation, the Annie E. Casey Foundation, Impact Community Capital, Deutsche Bank, the MacArthur Foundation, NeighborWorks America, and Wells Fargo) and advisory board, as well as **Joyce Klein** of the **Aspen Institute** who was instrumental helping think through and shape this roundtable.

INTRODUCTORY TALK

Roberts welcomed **Claire Kramer Mills**, Community Affairs Officer of the **Federal Reserve Bank of New York**, to provide an overview of the new small business lending marketplace. Kramer Mills began with three fundamental points: (1) small businesses are critically important for

growth in America; (2) it is vital for small businesses to be able to access capital to fuel that growth; and, (3) lending to small businesses has not yet recovered to pre-crisis levels. She presented findings from the 2014 Joint Small Business Credit Survey Report, representing the voice of small business borrowers in 10 states.

- Across the landscape, there are big differences in credit application rates – from 18% of microbusinesses (<$250K) to 58% of commercial businesses (>$10M). It's a tough market, with success rates ranging from 25% for microbusiness to 70% for commercial businesses. However, there is pent-up demand; 20% report they did not apply for credit because they anticipated they would be turned down. Kramer Mills said they're "rationally discouraged," because it's true that they probably would have been turned down.
- **Credit needs.** Small firms overwhelmingly need small amounts of credit (less than $250,000). Eighty percent of microbusinesses need less than $100,000. However, $250,000 and below is a challenging space for commercial lenders, since transaction costs are high. Reasons for borrowing differ between small and micro businesses. This has bearing on what products we're talking about when we talk about meeting the needs of these different parts of the market. Microbusinesses want flexibility through lines of credit and credit cards. Small businesses apply most commonly for loans and commercial mortgages.
- **Credit search.** Small businesses, on average, spent 24 hours applying for credit – the better part of a work week. Both small firms and micro firms are going to established institutions, though small firms are shopping around more than micro firms and are more likely to have contact with more than one type of source. Roughly one in five of each type of business is going online. Microbusinesses prioritize fast decisions, while small businesses are leveraging existing relationships.
- **Findings.** There is pent-up demand, but there are also "bankability" challenges. While self-reporting is challenging (Lake Wobegon effect), we do see profitability challenges (only 26% of micro and 61% of small businesses are profitable; only 39% and 60% have prior debt experience). Top reason for denial: low credit score. Top business challenges: attracting customers, uneven cash flow. (Credit-building products are

TOP 3 PRIMARY REASONS FOR SEEKING FINANCING N=588

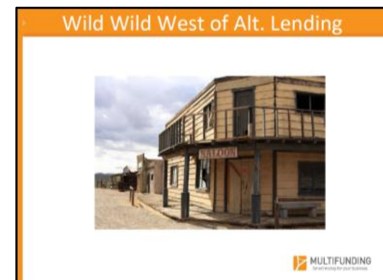
For what primary purpose was your business seeking financing in the first half of 2014?

Microbusiness (<$250K)	Small ($250K–$1M)	Mid-size ($1M–$10M)	Commercial (>$10M)
1. Expand business	1. Refinance or pay down debt	1. Expand business	1. Expand business
2. Fund day-to-day operations	2. Replace capital assets	2. Fund day-to-day operations	2. Replace capital assets
3. Refinance or pay down debt	3. Expand business	3. Refinance or pay down debt	3. Fund day-to-day operations

important! And firms that have gotten into trouble with high interest-rate loans, need to refinance.)

- “Up for Grabs” – what did you do if you were denied? Most contacted new/more financial institutions; roughly one-third of micro and one-fifth of small businesses explored online financing sources.

Ami Kassar of **MultiFunding**, a national business loan advisor and broker founded in 2010, said that MultiFunding has placed over $120 billion of debt in 41 states, with a median loan amount of $100,000. Lending is no longer a local business. Most of the time, he and a client will speak by phone but not meet each other – and ultimately find a better solution than the client would find on their own.



Kassar noted that we are living through the wild, wild west of alternative lending. Mitt Romney said, “We can’t run banks out of garages!” but the reality is that many exist now and many new ones pop up each week. How is this regulated? How do we know who is lending to whom? Almost anyone can get a loan. But can they afford it? Do they understand it? Many small business owners are not aware of their finances – and technology will never solve that problem. Many don’t know the difference between a balance sheet and an income statement. “Shoe box money” is not obsolete. Many of these small businesses are behind on their taxes and/or are not bankable. If they are bankable, they often don't understand the loans.

Kassar gave the example, that, when searching for a loan online, an ad often pops up offering “fast money,” and this may bring small business owners to companies and products that end up being dangerous to the business. The implication is, “Don’t go through the aggravation, don’t think about your loan search.” But what happens with such fast service? You get indigestion. an indigestion that can last for years or sinks the business.

Kassar noted that, often, the true APR is hidden in such ads. For example, the ad may say, “Borrow $50,000, pay back $60,000,” but the six-month repayment period plus daily repayment requirement means that the APR is really ~80%. Some short-term lenders are taking 30-40% of cash flow out of checking account every single day. Not many small businesses can survive that. Small business owners often don’t think about the impact on their cash flow, because they’re in emotional, irrational situations. Because these loans’ impact on cash flow is so tough, and because the owners are bombarded with new offers, they fall into a debt trap that spirals out of control. They face mounting debt through stacking, when another lender comes behind with higher rates and shorter amortization. From the lender’s perspective, if the lender has loss rates of 40%, it doesn’t matter because they’re having a hay day with the loans that they do collect on. There are hundreds of these lenders with rampant marketing schemes that make it sound so simple.

A few years ago, the only alternative to the Small Business Administration (SBA) was online lenders with 80-200% APR. (Kassar noted that his company loves the SBA Express Loan, with a 10-yr amortization at 6% APR. But, the application is time-consuming and has unique requirements that can be hard to meet, e.g., a good landlord relationship.) Now there's a space in the middle: a small handful of marketplace lenders willing to actually make loans that amortize over a couple of years, with no prep-payment penalties and transparent APRs. While they won't lend to as many people, they can get the loan done is a week with only one or two hours of borrower's time.

So how is Kassar's work relevant to CDFIs? Kassar said that his company is trying to do the right thing with businesses – but the sad reality is that they don't know how to work with CDFIs because CDFIs don't have scale or consistency of process. If someone is looking for a line of credit from a bank, Kassar's company knows what's needed; they know what documents are required and who to go to. With CDFIs, Kassar is confused. From his perspective, there's proof that the CDFI methodology works and Kassar is hopeful that CDFIs will partner to find better solutions to scale, so that we can work with you at a national scale.

Attendees were eager to share their observations and questions with Kassar:

- **Eric Weaver** of **Opportunity Fund** asked what lending volume level Multifunding would need to work with a CDFI with a national footprint and understandable process. Kassar responded that they could be flexible based on the product.
- **Kurt Chilcott** from **CDC Small Business Finance** asked how MultiFunding helps "shoe box" borrowers get credit-worthy – who does it and what does it cost? Kassar noted that Multifunding does not provide the education itself, since his business model is to close loans with an average 1.5 points on each loan. Rather, he tries to scare the living daylights out of them about the cost of financing and send them back to their bookkeeper, SCORE, or other educators. Kassar will say, "Come back tomorrow once you spend the night at your accountant" – and about 25% of the time after those conversations, they do come back.
- **Brian Rajan Nagendra** from **Living Cities** asked where MultiFunding's micro and small business funding comes from. Kassar said that, under $250,000, they disproportionately search from larger providers such as banks (though not exclusively since denial is high). The $250,000-to-$1 million range is a more complex story.
- **Carla Dickstein** from **CEI** said the "wild west" description of online lending recalled the early days of subprime mortgage and encouraged regulation. Kassar noted that, in addition to unscrupulous lenders, there are also unscrupulous brokers who take 10-12% without the borrower even realizing it – another area for regulation.
- **Napoleon Wallace** from **Self-Help** noted that, below $50,000, there's a great rate spread across the market - but wondered if there is a rate gap above $50,000, where there aren't credit cards. Kassar said it's shocking how many borrowers with $2- or $3 million in revenue are also taking short-term cash advance at high rates.

- **Tammy Halevy** from **AEO** asked Kassar to roll the clock forward five years beyond the wild west: what do you see? Kassar is both hopeful and nervous that the alternative lending marketplace will become bigger and more dominant. When regulators come in, "the cheese moves;" alternative and short-term lenders will find a different way to keep doing what they're doing.
- **Cathy Dolan** from **Opportunity Finance Network** asked what is the value proposition to go with a broker, if a borrower has the opportunity to identify online lenders easily? Kassar noted that the financial product that borrowers think they need is often not what they really need, so he adds value through advising them. MultiFunding's brokers identify their role up front and have a non-binding agreement to draw from MultiFunding's knowledge of different lenders and products.
- **Michael Swack** said that, historically, CDFIs' value has been in their contact with borrowers and ongoing technical assistance. What is the scale that a CDFI would have to achieve to attract attention? Kassar said he primarily wants consistency through similar documentation and products – at least 95%. "It's not about geographic spread. It's about transparency, consistency, and standardization of process. Else, it's too confusing; I don't have time."
- **Julie Eades** of the **New Hampshire Community Loan Fund** asked about intake. Rather than initial paperwork, Kassar said he prefers to first talk with borrowers and hear their story. Then he can explain what products make the most sense, what they can expect, and why. If they choose to work with MultiFunding, at that point he will ask for documents to send to the lender. Borrowers follow through about half of the time.
- **Cristina Shapiro from Goldman Sachs** asked about outreach and how MultiFunding aligns incentives with borrowers' needs. Kassar said MultiFunding does not pay for advertising. Rather, Kassar writes and speaks as an industry expert, and other advisers recommend them. They disclose that they only make money on closed loans. They also routinely fire lenders who aren't giving clients the right kind and level of service, i.e., if they're not transparent or not quick.
- **Bob Schall** from **Self-Help** asked if there are responsible and adequate sources of good debt for small and micro businesses? (For example, in payday lending, the problem is that consumers are steered towards bad products, not that good products aren't available.) Or are there gaps that need to be filled? According to Kassar, the answer is: "Both." There's a gap with start-ups (6-24 months in business) AND a huge education issue.

Panel 1:
Who are the Players and Whom are They Serving?
Moderator: Marysol McGee, Federal Reserve Board of Governors
There are a range of new firms harnessing a variety of technological innovations that are disrupting the small business lending marketplace; many are targeting or serving different customer segments. This panel will help map the current state of the market in terms of players, types of products, and the target markets they serve; and envision disruptions and developments that may be on the horizon.

Gina Harman, CEO of **Accion U.S. Network**, noted that her CDFI serves business owners, a significant portion of which are low-to-moderate income. Though their core product is term loans, in 2015, it feels a bit like "You can have any color term loan, as long as it's black – so we've been looking at other products too." In 2014, Accion did over 5000 loans, of which 75% were to borrowers with FICO scores under 625, LMI, women, and minority borrowers. In 2007-8, before anyone was doing this, Accion launched an online application with a big 'Apply Now' button. It was initially an experiment to see if people were shopping for loans online; in fact they were, and since Accion has launched several iterations of online loan application tools.

What is the role of 'touch' in borrower relationships? It seemed counterintuitive; Accion's model is effective due to a high-touch relationship with borrowers, yet their website is an online interface. Accion learned they had to build a direct sales force to understand borrowers' finances and help assemble their documents. There are also significant cost savings. Though donors paid for the upfront costs of technology development, by 2016, they expect to cut 50% of costs and be self-sustaining.

Accion's initial online borrowers were overwhelmingly male, white, and FICO >700. Advertising around key terms was driving a demographic that was not their core demographic. In order to continue to reach hard-to-reach, disconnected borrower, their 2014 reconfiguration included a financial resources library that would be a key for those looking to build and strengthen their business. Over just three months, they shifted business to their core demographic. Accion's experiences raise the question, "Does this wild west marketplace offer opportunity for CDFIs to reach into our target communities? Or will it exclude LMI borrowers yet again?"

Alex Dang, EasyPay Product Manager at **Opportunity Fund**, said its microlending products have been offered for 20 years. These were initially developed as an alternative to Merchant Cash Advances (MCA), with the same capabilities but with more reasonable rates and terms. They asked themselves how they can disrupt not-so-good players?

- MCAs have been around for 10 years and total market size is $9 billion. In addition to larger lenders, there are many small players, each trying to find a niche. Three or four years ago, we saw the emergence of Daily ACH products, which pull a fixed daily amount instead of pulling from revenues. More recently, short-term and long-term online loans have emerged with a FICO spread of 600 to 750 and an APR spread of 10% to 100%.
- Make sure you're benchmarking the right players. Amazon is a true technology lender, using its own data such as star ratings, inventory, and UPS shipping speed to target and assess borrowers. Everyone else is "shades of grey."

Tim Hatfield of **Lending Club** said that Lending Club has helped originate over $7 billion [now $9 billion] in total consumer and small business loans since 2007. Small business loans range from $15,000 to $300,000, with interest rates ranging from 5.9-25.9%. Lending Club is a platform that connects a borrower and an investor. For micro and small business owners looking for loans under $300,000, Lending Club can make an instant decision that includes the exact offer

including amount, rates, and terms. It's valuable for borrowers to understand where they fit in the marketplace.

According to Hatfield, it's important to understand how Lending Club fits into the marketplace as well. As a platform connecting borrowers and investors, "what we do best is to have low overhead. We're good at risk; we're good at data. We're NOT going to be able to go to a LMI community and bring them online. We don't have hands-on personal touch. We want to keep responsible rates because it's a core belief, but we also have investors looking for a return." Lending Club is aiming for the "efficient frontier of investing," in this two-sided market. They originate over $1 billion each quarter and still can't meet investor demand, since it's seen as defensive against other asset classes.

In a partnership with a CDFI, Lending Club would have to understand if the CDFI would invest and what their goals are, so that they can try to align incentives. Because CDFIs can access capital at cheaper rates (including credit enhancements) and require lower return than investors do, lower pricing could be provided to borrowers. The time it takes to build is a factor as well; if it's different from Lending Club's core product (e.g., if CDFIs need other demographic information and send through a state guarantee or secondary market), that's more difficult and harder to get up without scale. These difficulties are mitigated by volume – but the trouble is that CDFIs are building different systems based on different funder requirements, which makes consolidation difficult.

Lending Club is trying to push the envelope of reaching who is missing in the market. They recently announced a partnership with BancAlliance consortium of 200 community banks, in which consortium members could use the platform and offer a new product suite. Consortium members develop their own risk model and are the holders of the notes. Drawing on his experience working at Opportunity Fund, Hatfield proposed that Lending Club is a platform that could fit well with CDFIs because of its low transaction and underwriting costs and its ability to offer products that move quickly. Perhaps CDFIs could work with Lending Club on the origination side, finding borrowers in the communities, using Lending Club's platform to reduce costs in servicing and underwriting and still achieve the financial returns as an investor.

Clint Gwin of **Pathway Lending**, a 15-year-old Tennessee CDFI, said that their target is small businesses and scalable small businesses. They offer standard loans plus a few more specialized products, with transactions ranging from $5-10,000 to $3 million. Pathway Lending offers advising as well as products; "education is our differentiator, and what we're trying to emphasize as more players enter the market." Even larger companies can get in trouble trying to make payroll or pay rent.

Praising the Federal Reserve Bank of New York's survey, Gwin observed that Pathway Lending and CDFIs are targeting the same customer at the end of the day. CDFIs target borrowers who are challenged to access traditional financing because of their lower credit scores, limited or no collateral, and inability to project financial outcomes via traditional underwriting practices – which describes small businesses too. Most CDFIs have average loan sizes below $100,000.

According to Gwin, CDFIs have to do a better job customizing products for those customers and getting in front of them quicker and more readily. Gwin encouraged CDFIs to look into lines of credit and to prioritize education, which the market is missing currently. Other banks are beginning to pursue the same customers too. For example, banks through subsidiaries are getting into payday lending; they're trying to do it responsibility but there's only so much cost you can take out.

Heather Luzzi of **Golden Pacific Bank**, a 25-year-old small regional community bank in Sacramento, CA, described 'SmartBiz,' a partnership with a San Francisco technology company designed to bring SBA lending to the market and make it more accessible. SmartBiz has automated the lion's share of SBA's basic eligibility criteria. Initially, a borrower will log on to SmartBiz portal, key in data, then play with a sliding scale that lets the borrower know what fees and payment are for each loan amount. Then they enter minimal data to get through the pre-qualifier stage. SmartBiz works with IRS to get tax forms and captures bank account information online. An underwriter will do a cursory review to ensure accuracy.

Though not 100% automated, SmartBiz can pre-quality within five minutes, offer a full loan in 30 minutes, and close in 5-7 days depending on borrower motivation – much faster than the traditional process. The loans are also fair and reasonable for businesses; 10-year loans have 6-8% APR.

Even more significant than leveraging technology, the SmartBiz partners leveraged relationships and partnerships. They created national referral networks with the Small Business Development Center (SBDC) and SCORE, brokers, CPAs, and accountants. They haven't done a lot of advertising since it's expensive and has questionable return. Luzzi noted that the relationship part of this is key.

McGee asked what opportunities and challenges they envision for CDFIs.

- Dang believes CDFIs' opportunities are clear. In the SME market, CDFIs have the advantage of cost of capital. Savings go right in to the pocket of borrowers. There's also huge opportunity for CDFIs to offer more patient capital for borrowers' balance sheets. CDFIs can relieve businesses that are drowning with too many cash advances.
    - CDFIs need to level up with term time.
    - Tech won't be a cure-all. The worst thing CDFIs can do is to mimic the alternative lenders completely and then fall in the same potholes.
- Harman noted that the cost of technology has come down tremendously. It has been tough for most CDFIs to invest in developing a platform that can cut costs and enable them to serve a great number of people. But, it's needed, and there are enlightened funders, both in this room and elsewhere, who recognize it's important. Accion has seen modest investments free up staff time. A loan going out the door now isn't the only thing they measure – they can look into actual impact on families on communities. They can be fast in the areas of the process that should be fast and slow in the areas of the process that can be slow.

    - "Platforms" are the word of the day. Harman believes in them and hopes we're creating one that dramatically reduces the amount of time business owners hunt around. Accion wants borrower to be able to compare apples to apples across our loan products and make the best choice.
- Gwin said that historically, our industry has not spent a lot on advertising. But referrals from banks are one-off and far between. With reduction in technology costs comes an opportunity for CDFIs to change their dynamic. Take the case of payday advance lending. We have to educate entrepreneurs and small business owners on the front line. After payday advertising, the next advertising piece they should see is from a nonprofit helping them understand other options.
- Luzzi encouraged CDFIs to embrace technology, including and beyond education. "There's room for all of us in the sandbox. We can play together and do it fairly."

ROUNDTABLE DISCUSSION

Respondent **Bob Schall** from **Self-Help** observed that the United States has been an innovator in financial engineering – a double-edge sword. It's wonderful because it has lowered cost and increased access to credit, but these same tools and technologies have been used against people. The collapse of the mortgage market and the great recession came from the same securitizations and derivatives that were used for good. In the wild west of alternative lending, innovation is happening in an unregulated environment. That's what makes it wild! No one is protecting the borrower; but this economy and reduced technology prices also give us more leeway for innovation. In contrast to consumers, business people are risk takers and expect to be able to take risks, sometimes for good reasons! Therefore, CDFIs cannot blindly apply the same consumer protections to businesses. Schall proposed these principles:

- Provide responsible and reliable amounts of debt, in order to help a business stay alive over time.
- Base loans on the borrower's ability to repay and, ultimately, its long-term viability. Look beyond just FICO score and revenue.
- Increase liquidity. Loans should allow prepayment, not block other loans. This should not prevent other lenders from getting in there and providing even better products.
- Ultimately, the goal is transparent and comparable terms.

Schall concluded, "In this savage wild west, can we compete with borrowers who don't care about the long-term viability of our borrowers?"

Respondent **Jessica Milano** of the **U.S. Department of the Treasury** referenced the Federal Reserve Bank of New York's survey, especially pent-up demand. CDFIs can leverage technology to reduce search and underwriting costs and expand the pie to serve more borrowers, more quickly and affordably. She welcomed input on what role the CDFI Fund should play.

Swack opened up the broader discussion by noting that CDFIs' target markets aren't usually advertised to, so how do we reach them? Harman said that, thanks in part to the strength of their brand, Accion's organic traffic on their website produces a group of shoppers that are

their typical demographic and are responsive to their materials. Accion compared rates of people who come to them clicking from inside articles (e.g., how to calculate an APR) versus those who come through advertisements – and found that content pieces were converting at five times the rate of ads. Therefore, they adjusted where they were spending their efforts, doubling their commitment to posting new pieces regularly and using data to remove posts that don't work.

Noting CDFIs' historic high-touch approach in communities, Swack wondered what 'touch' looks like when it's online. Are there differences in performance?

- Dang said that all of their EasyPay loans have 'touch.' Opportunity Fund is lending to the same folks that alternative lenders are lending to, but their loans are performing better. Dang thinks this is because Opportunity Fund has a relationship with EasyPay borrowers and understand their situation, so they set the right rates and terms and also can work with them if they come across hard times. 'Touch' is meeting borrowers where they are. Ultimately, they have a conversation about whether EasyPay can underwrite the loan, what are the terms, and do the math with them so that they know that EasyPay understands the merits of their case. Prior to this conversation, if a borrower is not comfortable communicating their viability, EasyPay will hand-hold. But EasyPay doesn't force borrowers to go through a pre-loan technical assistance process if they want to go forward and are pressed for time.
- Hatfield observed that, because 'touch' also creates expectations, you have to be careful. If you invest five hours in talking with potential borrowers, you get to know them, you like them, and you might take risk outside of what you'd normally do. Or, you may disappoint them, if you need to decline them after 5 hours or days of getting to know each other. Relationship-building with Lending Club is that everyone gets a client advisor, so they know who to call. It's important to understand how far you go into that process. If you decline them five minutes into process and explain why, you can help them understand where they fit in the landscape.
- Harman still believes in 'touch.' One of Accion's leverage points is 100 staff in major cities across the country. For 2015, they expect one third of their loans to come from referrals, including from those researching debt options online. If you submit an Accion application, today they promise a response in 48 hours; by the end of 2015, they will respond in less than one hour. Accion is not replacing the old process; they are simply acknowledging that people who are looking for debt are doing it online and finding lots of options. It's about understanding how people are looking for debt; connecting supply and demand; and leveraging data to make better decisions.

Other attendees were eager to join the conversation.

- Consultant **Charles Tansey** sees great opportunities for partnerships between CDFIs and technology platforms, including incorporation of technology platforms into CDFIs. How can CDFIs collect data so as to understand borrower dynamics? Are online lenders now able to access these data?

  - Hatfield said Lending Club has three floors of engineers building systems to gather data-sources in an effort to make a better decision. It's very secure, but it's a challenge to overcome misperceptions about security. His advice is to look at every document you request, see if it adds value, and to think strategically about if you can you get those through online sources and what is the true risk you determine through that process.
  - Luzzi said that her borrowers sign a form that she exercises directly with IRS.
  - Gwin recommended ProfitStars, a Jack Henry company, for a secure turnkey solution. As background, Pathway Lending knew they didn't want to develop the back office technology in-house. Their 18-month national search for vendors led them to Jack Henry, which they felt had the balance sheet and capital to continue to invest in the product. Online visibility of borrower's daily sales has allowed them to give larger loans at lower rates. Now Pathway Lending is working with Jack Henry to offer the program to other CDFIs, with Pathway Lending serving as an intermediary.
- From his perspective of a regulated depository CDFI, Napoleon Wallace from Self-Help observed that most of the activity is in the unsecured space. Are there any leaps in technology that could be useful to us to do an SBA 504 or asset-backed product?
  - Gwin, a former FDIC regulator, noted wryly that all capital requirements can be overcome with more capital!
- **Frank Altman** of **Community Reinvestment Fund** asked panelists, representing both national and local organizations, what they see as the risk to CDFIs going online and getting applications outside of approved target market/service areas. How do they handle it?
  - Harman said Accion lends all over the country. They wouldn't have invested in their platform if it could only amortize over two states. "If we're successful, we're not going to be able to handle the volume. We're looking for sustainable businesses. I can foresee a time where the value of the platform we built will get amortized over a larger number of organizations and CDFIs that see opportunity for equal value exchange."
- **David Sand** of **Community Capital Management, Inc.** represents investors that want to buy loans in the "right way." He wondered how to compete at scale when there are 5-8% bounties being paid by competitors. Dang noted that bounties are actually as high as 12% plus kicker, depending on volume and that the field needs to think outside of online advertising. SBA LINC is supposed to match small business borrowers with small business lenders. CDFIs should resolve to fill that gap, piggyback on the brand power of SBA, and look for the opportunities that non-CDFIs can't go after.

DAY 2: LOOKING AHEAD

Swack began the second day of the Financial Innovations Roundtable with a recap of the previous day's discussions, in which we learned:

1. There is a clear demand for small business credit;

2. Many community development lenders have managed that risk and expanded their services to underserved people and communities;
3. Platforms have been built that have amazing abilities to process information quickly and efficiently.
4. Some CDFIs have begun to utilize these tools, while also maintaining key elements of 'touch.'

Swack reframed Connie Evans' observation: "We CDFIs have been doing this for 30 years – that's good. Unfortunately we don't have any transformational news after 30 years of working…" But Swack noted that we do have some good news: we have powerful new tools, client demand, organizations doing lending, and government and other supporters (including here in the room today). The CDFI industry has all the pieces in place to dramatically expand lending in communities. With 30 years of experience doing this lending, CDFIS now have powerful new technologies that will allow them to do more.

The challenge is, putting these together. <u>Can the CDFI industry see a BIG leap over the next 5 years – over the important, but small, leap that they have made over the past 30 years?</u>

Patrick Kelly, deputy chief of staff for the **Small Business Association (SBA)**, said that 'transformational" is a good word to describe the advances and potential advances through technology to small business lending. Historically, the field could have speed or certainty but couldn't have both. If a lender wanted a decision in 48-72 hours, programs like Express allowed delegation to the private sector, which took a risk in order to be competitive; but you weren't certain that guarantee would be there. If a lender wanted certainty, you went to SBA district offices or process centers and you suffered delay. If you were a CDFI or CDC or microlender, you didn't have speed OR certainty because we didn't let you use these. Now, CDFIs and CDCs can use the SBA's 7(a) loan program guarantee, for the same reason that banks and credit unions have historically enjoyed. Liquidity and the ability to sell on secondary markets are a tremendous advantage and a tremendous asset. Now, there is opportunity for community organizations to have same asset as banks and credit unions.

The SBA has allowed credit scoring for years. Banks have always been able to do unsecured loans, back to the LowDoc program of the 1990s. But only a few large regional or national banks took advantage of that, those that had large budgets to create or license tools. The majority – community banks – still relied on financial spreads, doing things the old-fashioned way.

When penetration by higher-speed products began to impede on this space, SBA introduced LiquidCredit, capturing business credit bureau scores as well as personal credit scores. Since 2012, 26% of loans have been in the "lower-right quadrant sweet spot," meaning they are a solid business, probably built on the backs of individuals' credit scores. Close to 2,000 banks have used the tool to make 20,000 loans under $350k, totaling $1.75 billion in loans. Today, SBAExpress accounts for 62% of originations, and LiquidCredit is on an even stronger trajectory. Any institution can tap into the ability to do credit scoring.

On March 30, 2015, SBA aims to make the first loans live with an alpha tester on a new platform called SBA One, which is a soup-to-nuts loan platform. SBA One begins with a tool called Rapid, to which a borrower uploads application materials that cascade throughout the loan file for later use during underwriting. Second, there's an eligibility module; if you know what you're doing, there's an Expert Path, or you can also choose Guided Path which dispels and lays bare myths about lending. Guided Path has close to 500 pages of Standard Operating Procedures (SOP) distilled down to TurboTax-type easy questions and prompts. Third, SBA One offers DocuSign. Supporting docs can be stored electronically in perpetuity. Finally, SBA will update and integrate SBA LINC. Today, a borrower can enter basic information, and over 200 lenders in network will receive the request based on geographic scope. The lender has 48 hours to opt in or opt out to interact with borrower; opting in leads to direct communication with borrower.

<u>SBA One introduces certainty without reducing speed.</u> Speed and certainty become one. Previously, a $387,000 loan would have cost $11,000 and taken 100 hours. Lenders estimate SBA One will reduce this to $4,600 and 13 hours total. Additionally, SBA is working with the Treasury Department to create a direct, real-time interface for the 4506-T tax transcript request. Today, you can pay a third party for direct service, or it can take up to 45 days. What you see today on SBA.gov is the tip of the iceberg of what's possible. There's no reason that SBA's public-private partners can't benefit from these tools.

Attendees had questions for Kelly:

- Kassar asked about rethinking the landlord requirements for a 10-year lease option; this hurdle disqualifies half of the people they put forward through SBA Express. … Kelly said there will soon be the option for unsecured business loans up to $350,000.
- Altman said that the Community Reinvestment Fund has been developing a platform very similar to SBA One. Will SBA certify other platforms for the same purpose? … Kelly said, not at the moment, but this is something the next SBA project manager should consider.
- **Ellen Seidman** from **Urban Institute** asked if SBA One will be available to banks and credit unions. Kelly said, yes, to anyone doing 7(a) loans, including CDFIs and CDCs. Will also build same platform into the CDC/504 loan program.
- Shapiro asked, why not extend access to lenders beyond SBA loans to support with other decision loans, since this would increase efficiency? Kelly said that access is already available for Community Advantage lenders. For SBA microloans, it's a slightly different dynamic; they are still trying to figure it out. It's evident that they should move to this, but it will take longer than it should.

Panel 2: Opportunities for Learning and Collaboration
Moderator: *Michael Swack, Carsey School of Public Policy*
As we work to address issues affecting small business access to credit, we would also like to explore opportunities for community development lenders to learn from and collaborate with

the new players in the industry. This panel will explore a variety of opportunities in a conversational format.

Chinwe Onyeagoro, CEO of Fundwell, said she started as online financing broker – like Kassar, trying to solve the 'finding cost' problem. As thousands of businesses started using the site, she thought they would choose the lower-cost lender. That was not the case. They went to the fastest lender. The conversion rate for the fastest lenders was three-to-five times that for the slowest. So Fundwell built a tool to help. They have 300 lenders funding the full continuum of risk profiles. Their market is those with a FICO score of 640 and above, at least $100,000 in revenue, and decent cash flow.

Frank Altman of Community Reinvestment Fund said they are a national CDFI that both lends directly and supports the lending activities of other CDFIs and non-bank lenders, bringing capital and liquidity to other organizations. They recently became a 7(a) lender. They just crossed the $100 million threshold in SBA loans, in part because of new system that dramatically reduces cost to originate and speed up originations. They are making this system available to the SBA and ultimately CDFI communities.

Daniel Gorfine joined **OnDeck Capital** recently from the Milken Institute, where he focused on expanding access to capital. OnDeck has lent $2 billion to businesses. Gorfine said he would like to clarify common misperceptions about OnDeck. The median age of OnDeck's small businesses is 7.5 years and the median revenue is $570,000. Their average loan size is $50,000 and average loan duration is 11.5 months. OnDeck offers true loans, not advance products. They are primarily an on-balance sheet lender, but do have a marketplace where loans can be purchased by institutional lenders. OnDeck wants to build a sustainable, scalable model that serves small businesses. They pass on savings to customers; for example, they have served lower pricing over nine consecutive quarters. OnDeck's focus is access, speed, and service. They believe FICO is a poor proxy for the health of a small business, so their fifth-generation credit scoring system analyzes thousands of data points and can work across more than 700 industries. OnDeck has an A+ rating from the Better Business Bureau and a strong brand rivaling Apple and Southwest. They offer their technology, free, to mission focused lenders through AEO. Ultimately, they'd like to offer OnDeck to more CDFIs through the AEO program, who would then set the price, maintain the relationships, and fund the loan.

Rohan Mathew of **The Intersect Fund**, a nonprofit microlender and CDFI based in Newark, NJ, serves people who aren't in the financial system or who fall through the cracks, e.g., don't have social security numbers. Loans average $5,000, which helps clients formalize their businesses and take them to next level. The Intersect Fund's lending platform is 100% proprietary; they have strong tech backgrounds and six developers in India. Half of their staffing is in sales, knocking on doors, making phone calls.

- Mathew said they are in an AEO pilot group which allows them to license the OnDeck platform for free; it's invisible to borrowers. "OnDeck has pushed us in our thinking; if they make a business decision in a day, we should be able to." However, even standardization of documents is a challenge.

Pam Porter of **Opportunity Finance Network (OFN)** said that OFN's support for industry best practices includes helping CDFIs aggressively build small business lending programs. This work is supported by Goldman Sachs 10,000 Small Businesses.

Swack asked panelists to name their single biggest challenge as they hope to grow. Is it cost of customer acquisition? Speed of processing?

- Onyeagoro cited customer acquisition costs and transaction costs. Many customers are looking online and that number is only going to grow. Trusted influencers in financial literacy are a tremendous jumping off point. Accordingly, Fundwell developed a marketplace tool that could be implemented on any site, with a 'no wrong door' philosophy. Fundwell has over 100 widgets on the websites of chambers of commerce, commercial real estate brokers, and accountants, so that businesses looking for capital end up in the right place to apply for loan. They have an 80% loan approval rate if you apply through the lender we recommend, in contrast to 30% in the market generally.
- Altman said, reducing origination costs.
- Mathew said, finding good talent, especially salespeople with both sales skills and knowledge of the territory. He has hired used car salesmen, but there's no good pipeline for people with small business experience.
- Gorfine asked rhetorically, "How do we move this space from 'alternative' to mainstream?" In the U.K. and elsewhere abroad, policy-makers embrace the role of technology in financial services, for example, suggesting that traditional banks refer declined small business applicants to online lenders. This, in turn, can help to lower borrower acquisition costs and overall pricing. With CDFIs in particular, a key barrier to overcome is ensuring that CDFIs understand how a partnership through AEO would work, and how the CDFI is able to maintain control over the customer relationship. OnDeck's support of the AEO Tilt Forward Initiative allows CDFIs to focus on high-customer-touch and the things that they do best.
- Porter named two challenges: (1) Customer focus. By mission, all CDFIs are connected with their borrower succeeding, but you can't tell when you go to their website. Is there a tension between websites promoting mission and making it easier for borrowers? (2) Living up to customer expectations. Can we make the process easy, transparent, and fast?

Swack asked panelists where the opportunities are for transformation.

- Mathew observed that technology brings the potential for new business models, including online customer acquisition or data-driven decisioning. The closing table is a key opportunity for education. The Intersect Fund created software that allows borrowers to customize their loan; borrowers can see how it would affect costs if they changed terms (there is a slider in the interface), put assets as collateral or not, changed date of payment each month, and so on. This puts power back in the hands of the borrower and helps them understand the transaction. It deepens the customer relationship.

Swack said that the CDFI sector has organizations that understand community lending, but don't have much technology (with notable exceptions of SBA One, the Community Reinvestment Fund, and a few others we've heard of today). He asked Gorfine, "What if we wed CDFI knowledge of market with the skills, technology, and learning that have been developed by OnDeck and others? You could white label the OnDeck technology and CDFIs could use it for free; then they have a tremendous tool. Whether it's OnDeck or another online lender, shouldn't this be easy – and transformational?"

- Gorfine said that AEO is trying to solve coordination problem with lots of different CDFIs. OnDeck is 100% focused on Main Street businesses. If this is a model to better serve them, OnDeck wants to support this.

Swack then turned to Porter. He observed that CDFIs historically have resisted standardization, even things that are seemingly irrelevant (such as application forms.) OFN is working with 24 CDFIs on business lending issues; "why not standardize right now?"

- Porter said one goal of this two-year collaborative is to look for more standardization opportunities and test drive technology initiatives, serving as a laboratory for testing.
- Swack urged Porter to "look Daniel in the eye and ask him what you might learn from him." Porter named the opportunity to test drive a platform with small group, see what works well and doesn't, and explore the partner's ability to make modifications.

Altman observed that we are at the end of the Roman era of organizational form, i.e., the self-contained vertical. The Internet has exploded this model. If The Intersect Fund is using OnDeck to underwrite its own loans, why can't we take this model further? We have a large group making loans, with high costs to maintain their vertical. For the $700 billion we collectively control, we should shift from 'lock-step vertical' to 'networked.' The Community Reinvestment Fund is working with Fundwell and would love to be the front door to someone else's capital. Use the best practices and bring to a standard that can go across the industry. It's a change to the basic CDFI operating paradigm.

- Onyeagoro recalled her TED talk in which she said that one indicator of inefficiency is industry silos. The network model is more efficient. A 'no wrong door' approach when borrowers are graduating repositions them for refinancing tomorrow. There's a point when the borrower qualifies for SBA, but they don't know it. If we had truly networked marketplace, a borrower would be in a position to know when they are ready. Lenders would see it as their enlightened self-interest to follow up and/or refer borrowers elsewhere.
- Swack observed a mismatch between how lenders see themselves and their ability to collaborate. CDFIs think they're 'unique,' but actually 85% of what they do is in common. How do we get around this?
- Altman recalled a 2006 paper by Kirsten Moy and Greg Ratliff about how CDFIs get to scale and where they have fallen short. Historically CDIFs think: first innovative, then replicate. But that approach isn't successful. How do CDFIs collectively build scale

across the industry and build standardization, infrastructure, and other things that are attractive for securitization and attracting more capital?

Respondents

Cristina Shapiro of Goldman Sachs first referred to Yunus' assertion that access to credit is a human right. What do you mean by credit – what type of credit, and by what standards? If you're going to partner with or marry someone, you want someone who shares your values. If your widget ends up somewhere else, you want to be sure it's in line with your goals for those borrowers. Shapiro identified opportunities in origination; where are the people that OnDeck and Lending Club are not funding, and can CDFIs help them end up in the right place?

Shapiro noted that CDFIs are amazing, but also their own worst enemies. If CDFIs can standardize 20%, it's still a net benefit. Standardization and aggregation are not all or nothing. Take steps towards a networked approach. Shapiro mused whether funders need to be more creative and should have invested grant dollars differently, towards standardization instead of individual grants.

Connie Evans of **Association for Enterprise Opportunity (AEO)** joked that, if alternative lending is the "wild, wild west," the CDFI marketplace is the "wild, wild Midwest." Standardization and infrastructure are two important pieces that get the CDFI industry to transformational change in the development finance industry. Standardization will not make CDFIs lose flexibility if it's done effectively. The Intersect Fund's (and Justine Petersen's) experiences on TILT Forward platform has allowed them access borrowers they wouldn't have. By standardizing, CDFIs are most importantly giving choice to entrepreneurs in the community, and freeing up time to give guidance to those entrepreneurs.

- Evans also noted that standardization of products is critical to access the secondary market. CDFIs are too small to raise the tranches of capital they need to fuel their growth. AEO has created a nonprofit shared utility called the DreamFund, which purchases loans that have been made on the TILT Forward program. This secondary market is a piece of the infrastructure currently missing.
- Evans noted that standardization will go a long way to solve the interface need for companies like OnDeck that can't customize for every CDFI. The goal is to network best-in-breed technology with CDFIs' 'secret sauce' of community knowledge, to create new structures that lower cost for entrepreneurs and create new opportunities for investors.

Open Discussion. Other participants continued the conversation about value proposition in a networked model.

- **Joyce Klein** of the **Aspen Institute** said one reason there is not more standardization is that there's a lot of diversity in this market. Even within microlending and small business lending, there's diversity in what people need. We must keep this in mind as we fashion products.

    - There's also a money challenge. If I'm a CDFI and you're already 25-50% self-sufficient and you take away the lending and just do the 'touch,' you've taken away my business model. We'd need different funding for education to move in this direction.
- Altman: 'Collaboration' is the wrong word. "It's really about a value chain. There has to be value exchanged, or it's not going to work." The Community Reinvestment Fund pays their CDFI lenders a hefty fee for the deal they bring. It's not as much as the loan, but they're also not taking the risk.
- Porter: 'Value proposition' should be a strong guiding principle. CDFIs are connected with their mission, but that's different than value proposition. If we want to grow small business lending, we need a laser focus on the value proposition – making sure all interactions with customer and all of their processes and products align. This can be a clarifying concept to help CDFIs make decisions about collaboration. What's the only way to help customers to faster decision? Achieve successful use of technology and most effective collaborations. What's most important to their most important customers?
- Mathew: Why are there not more for-profit companies offering software in this space? As an industry, we're crappy customers. We don't want to pay what it's worth, we want everything perfectly customized, and we want someone available whenever we want to reach them. For The Intersect Fund's proprietary model, there's no economic model for us to license out and support. Technology is an operating expense, not a one-time expense. If you don't continuously invest in development, platforms will decay and lose their usefulness.
- **Patrick** of **NYCDC** questioned The Intersect Fund's social model, observing that businesses that don't file tax returns and/or are run by owners who don't have social security numbers usually also treat employees poorly. He felt the model is at best neutral, at worst damaging and enabling. Mathew replied that you have to meet businesses where they are, not where you think they should be. It's easy to pull the wool over your eyes and say a business should do XYZ, but reality is that this doesn't happen. Instead, you use financing to become trusted advisor of business, so you can tell them what they need to do to get bigger loan. If you decline someone, it's not a learning moment.
- Dang challenged credit reporting practices by alternative lenders, especially OnDeck. When the Opportunity Fund works with borrowers, "I can't look at a credit report, because there's hidden debt. It's a huge risk to us; we've stumbled upon land mines." Gorfine responded that OnDeck does report to business credit bureaus. *[Ed: The contention appears to be around reporting to personal credit bureaus, since many entrepreneurs take out personal loans instead of small business loans to support their business.]*

Panel 3: Building Products that Strengthen Small Business Borrowers
***Moderator**: Joyce Klein, FIELD at the Aspen Institute*
While technology and innovation have done much to encourage investments in and growth of a variety of new small business lenders, there are still opportunities to develop better and more

innovative products that effectively address the needs of small business borrowers. This panel will discuss how we should define and advance the provision of responsible practices and products in this marketplace, and the role of mission-based lenders in this process.

Klein noted this is a timely conversation. Ten years ago, banks were offering credit cards to small businesses, and we thought this meant a narrowing of the market traditionally served by CDFIs. Then the world changed: banks moved out and haven't moved back in. For microlenders, there was pressure to grow; they began to see formerly-bankable customers they hadn't seen before. Now, technology is further changing the landscape. For CDFIs, this brings both opportunities and challenges in lending policies and practices. What is our responsibility not only in our own lending, but also to help shape the marketplace to meet our goals of building businesses that can survive, thrive, and grow?

Panelists:
Catarah Hampshire and **Shoneji Robison** are co-owners of **Southern Girl Desserts**, based in Los Angeles, which recent won the *Cupcake Wars* reality TV show. Hampshire and Robison started the company eight years ago in one of their homes. They moved to commercial kitchens, then had the opportunity to open their first storefront. Like most business owners, they didn't have financial backing, so they started with personal finances and personal credit. Hampshire maintained a full-time job so had stronger credit; Robison jumped in full-time to the business. Payroll became a challenge. They first went to their own bank where they deposit money every month and naively asked for a loan. They were graciously declined.

- They weren't looking for merchant cash advance companies; rather, the companies came to them, with an amazing story of getting the money into their bank account in two days and not judging credit. It sounded great. Hampshire and Robison paid the loan back in six months and were good to go. "When you get into that type of flow, it becomes something you depend on. We could get $75,000 every six months, help our cash flow, and get the machines we need."
- Then Hampshire and Robison got a huge loan from OnDeck. The percentage rate was really high, over 50%. They weren't concerned because they needed the money and OnDeck gave it to them without hassle. "We thought we were qualified for SBA loans, but we weren't getting them. Six months later, OnDeck was taking out daily withdrawals, a huge portion of our cash flow. We were going nowhere. Then we got a letter from the Opportunity Fund that said, 'If you are in a merchant cash advance and need to get out, we can help.' I cried because I knew this was different." Their rate with Opportunity Fund is under 10%. They now have cash flow, can make payroll and pay themselves, and run the business knowing that their profits can be reinvested instead of going to merchant services.
- Alex Dang was their contact and was wonderful. They just met Alex for the first time in person today. "'Touch' can occur over a distance!"
- Hampshire and Robison noted that good money needs to be presented to business owner. They were directed; they were told this was the best they could get.
- In hindsight, Hampshire and Robison reflected, "We could read what the loan materials said, but when you're in the position of needing the loan, you rationalize differently,

you're in panic mode. It's not as though the information isn't there, but they make it sound so lovely – until ACH withdrawals start happening."

According to **Eric Weaver** of the **Opportunity Fund**, all the information was not presented to Hampshire and Robison and other similar borrowers. From what merchant cash advance companies or OnDeck tells borrowers, they have to calculate their own monthly payment and annualized interest rate. If this information were front and center, you'd think, maybe I don't want to borrow this much. Southern Girl Desserts was a happy story, in that Opportunity Fund was able to capitalize all four of their loans. But often people stack and borrow so much, that Opportunity Fund can't extricate them. According to Weaver, "we've got a reckoning coming. The 'wild west' was a very dangerous place; people got killed. Now, businesses are getting killed. We need a Wyatt Earp. In the meantime, we need vigilante justice, a neighborhood watch that we can all do together (and some of us are)."

Barbara Lipman of the **Federal Reserve Board of Governors** has researched how 'mom and pop' business owners look at different financing options including online. Expressing her own views, not necessarily those of the Federal Reserve System, Lipman noted her study convened a group of 'mom and pop' businesses with under $2 million in revenue, fewer than 20 employees, and in business for more than two years. She held an online focus group to get at the sources of their financial stress, how they view borrowing decisions, what their perception is of online lenders, and how they evaluate products.

- Study participants were diverse – they included a hairstylist, clothing importer, architect, auto mechanic, and other typical small businesses. They received $150 from the Fed for their time. The format was a moderated focus group conducted over three days in which participants logged in at their convenience to post responses to a moderated discussion online. In terms of their candor and detailed responses, participants exceeded expectations. To the extent similar research is done, it is likely by private companies that tend not to release their findings publicly.
- At first, participants' perception of online alternative lenders was mostly negative. The notion engendered skepticism. Then, participants were asked to visit the websites of online companies and to poke around and report on what they found. There was a slight shift in attitude after viewing. The websites are alluring and appealing; they cater to simplicity and ease of use. The potential borrowers wrote such comments as: "Interest rates were not as high as we thought" and "Decisions are based on business history instead of on credit score. This gives us hope…" However, there were countervailing concerns about the security of information; participants were turned off by attempts by online lenders to gather sensitive business information from website visitors right away.
- The next stage of the study was to ask borrowers to examine mock products on a virtual white board. Asked whether comparing products was easy or difficult, most participants said it was "easy." However, when asked specific questions about the products, many couldn't actually answer questions correctly. Finally, the potential borrowers were asked for recommendations. To a person, they recommended full

disclosure, consistency and common language to compare terms, ironclad security of information, and assurances about the companies they're doing businesses with.

Brayden McCarthy of **Fundera** pointed to Karen Mills' articles in Harvard Business Review and Forbes that analyze the state of small business lending, including online alternative funding. The distinction between 'consumer borrower' and 'small business borrower' needs to end in his opinion, because there's not much of a difference. If you search online, you find identical promotion. Fundera tries to find the lowest-price capital given a borrower's profile. Borrowers want, and Fundera wants for them, choice architecture in this space.

Choice architecture is the responsibility of the broker. They're meant to be an impartial advocate, to educate the borrower and make sure they understand the "five C's" before making a decision: Comparability, Choice, Capacity, Conditions, and Collateral. A lender shouldn't be selected for you without you knowing what your other options are. Fundera's fiduciary responsibility to the world is for lenders to know that they are competing with other lenders for offers.

Brian Graham of **Alliance Partners** partnered recently with Lending Club to develop the BancAlliance network, a shared lending platform that provides community bank members with a broad array of loan programs and services, including sourcing, underwriting and managing loans. Historically, all of these programs and services had to be in one shop. Citing Frank Altman, Graham said that, fundamentally, this is about breaking apart the value chain. The beauty of technology is that it allows everyone to do what they do best. The challenge is that it allows all sorts of people to participate in early stages. Some chaos is inevitable in a period of growth and innovation. Graham echoed Eric Weaver in calling for 'rules of the road' and finding the right array of partners across the value chain who can treat borrowers as long-term relationships. Transaction-based businesses will fail – and the sooner, the better.

Napoleon Wallace of **Self-Help** said the Southern Girls Dessert story recalled for him the outgrowth of horrible stories in Self-Help's lending area that was the impetus for their Center for Responsible Lending. According to Wallace, Southern Girls prompts a conversation on how we can put regulation around this market. Payday lending is not exactly applicable, but has similarities, including issues around price transparency – it is a fee? An interest rate? Stated as dollar amount? Or APR (which is easier to understand and has applicability across products)?

The sales culture of online lenders is phenomenal. You get texts, letters, people calling you every day. The most predatory part is their ability to be 'top of mind,' especially in moment of desperation. It's also not transparent whether brokers have an incentive for someone to be placed in high-rate loan. In this room, we have the products, but we don't have 'feet (actually, mouthpieces and earpieces) on the ground.'

Klein asked the panelists how we get in front or put the right pieces in place.

- Weaver quoted Martin Eakes, "The good money will never outcompete bad money." Ultimately, we do need regulation. What are CDFIs good at? Getting subsidized capital

and underwriting hard-to-score borrowers. That's where we should put our efforts. Send easy-to-score borrowers to responsible partners.

  - Weave noted that it's scary to think about giving up the lending function. CDFIs operate in a hybrid model. With most of our funders, if we stopped doing lending, they stop funding us. They're not going to fund us to direct people to Lending Club. We would need to get paid, because we couldn't fundraise like we had before.
  - Weaver also noted that, while we're waiting for regulation, which should and will come, we should develop a seal of approval, best practices list, borrowers' bill of rights, or something similar. Pick a few big things that we can agree on and try to get as much attention to it as we can.
- McCarthy is not sure regulation is coming soon. The Consumer Protection Bureau would be the one to do it, but doesn't have the authority.
  - Wallace said that, as an investment banker, he wants to agree that the markets will find solution on their own – but if businesses are going under, the cards are stacked in favor of bad actors in this market. The fact that we've done this before as an industry with Dodd-Frank positions us to move a form of legislation quickly.
  - Lipman reminded us that "online is a place, not a category of loans." There are already a series of regulations for loans.
  - Graham said plenty of participants in this space do want to keep a responsible, sustainable approach. There is a framework for market to take care of itself. Also, banking regulators have significant influence through the necessary participation of banks in this space in a number of roles.
- Onyeagoro is not sure if access to credit is a basic human right, but believes equality of opportunity in seeking credit certainly is a right. FundWell created a bill of rights – for example, the right to control one's own information, since big data opens up whole new potential for discrimination.
  - Weaver suggested another right: for on-time payments to be reported to credit bureaus, so borrowers can move towards bankability.
  - Graham recommended keeping it simple. "Fifty pages of legalese is not disclosure and doesn't achieve anything."

Respondents

Annie Donovan, Director at the **CDFI Fund**, said the last two panels exemplify both the opportunity and threat. Technology is neutral; it's what we do with it. Are there going to be bad actors? Human history suggests, 'probably, yes.' This last panel identifies the sweet spot, the value proposition, for CDFIs. Just as the Opportunity Fund did, go into a market where there are potential abuses, develop a tool to promote access, and offer a responsible product. If technology comes along that supersedes us in building access, let's move out of the way; we don't need to be in a market where for-profit players are doing it responsibly.

Responding to Swack's provocation about what CDFI Fund can do, Donovan noted that the CDFI Fund is celebrating its 20th year anniversary and has solid track record on which to build, including research by Swack and by Greg Fairchild on regulated CDFIs. The CDFI network is a "national treasure." CDFIs have done a lot of good, but on a tiny scale. This year, to prepare for next five years, they are going on a listening tour to develop their strategic framework. They will be asking for input on six broad topics: (1) Data; (2) Innovations that are needed to move needles; (3) Growth and impact; (4) Access; (5) Operations and customer service; and (6) Other blind spots we should be looking at. Online marketplace is accelerating conversations we've had for years, e.g., standardization.

Open Discussion.

- **Carla Dickstein** from **CEI** pointed out that state activity pushes the national dialogue (as with subprime). In Maine, a proposed bill would put a usury rate on lenders.
- **Tammy Halevy** from **AEO** heard three main points: (1) CDFIs' secret sauce is low-cost capital, hard-to-reach borrowers, and social justice; (2) There are opportunities in big data; but, (3) CDFIs can't give up lending. Is there an opportunity for our learning to lead to product development and income development for CDFIs?
    - Weaver: CDFIs are not used to figuring out what they know and selling it. They're used to tinkering, making mistakes, not readily sharing. Young people in the room may be better at figuring this out than we have been. We need a completely new business model if we give up lending. It's a rare organization that can take itself apart. We may need completely new organizations.
    - Onyeagoro: we pick winners too quickly and try to scale those based on our omniscience. Instead, we should learn from for-profit companies. Instead of selecting one vendor, create an accelerator for companies with our group of beta testers. In the end, clear winners emerge because they actually delivered, not because of relationships. It's too early to standardize; it's too early to pick winners. Your asset is organizations that are already in the marketplace doing it. Don't pick winners, pick opportunities to test.
- **Richard Neiman** of **Lending Club** asked Brian Graham for insights for CDFIs – you have to create a world in which institutions can choose whether to participate. You have to create incentives, not force partnership. Let forces of market and incentives drive the right behavior. If you try to force everyone to sign upfront, it's completely unworkable.
- Cristina Shapiro asked Graham if it is possible for CDFIs to do something similar to what Alliance Partners did with Lending Club for community banks. Graham said, yes, it's both possible and necessary for CDFIs to participate in collaboration. Technology has brought fundamental changes. It is necessary for CDFIs to adapt and fulfill their mission more broadly. How? It's all about finding the right partners with mission alignment and a long-term perspective. "Before we crafted our partnership, we went on a lot of blind dates."

Roundtable Discussion

After a short break, participants discussed how we might move forward in creating products and practices that promote the long-term growth and strength of the small and micro-business sectors.

- **Pat MacKrell** of the **New York Business Development Corporation** is a big fan of Eric Weaver's "vigilante" approach. The New York Business Development Corporation got into small business lending because they were frustrated by the lackluster recovery of small businesses after the great recession, especially those owned by African Americans. Through thought groups, they discovered a lack of financial preparedness. Color is the '6th C' of credit; there's a 'black tax.' When black small business owners try to complete a CDFI application focused on service to minority communities, there's both a lack of sophistication and a fear of color (which is partially mitigated by online lending platforms).
    - "The things CDFIs care about, I'd be thrown in jail talking about as a lender. How do we keep the focus on the social, preventing destruction of lives due to poorly conceived capital stacks?" We do need to be vigilantes; for example, creating exit strategies to a more sophisticated bank-like program. We are only focusing on New York because we have physical location and believe we need 'touch.'
    - Swack observed that the New York Business Development Corporation has been lending since 1955 and is now moving into CDFI mission space. He asked McCrill how they can take the skills and experience they've already built and their significant capital base and make their mission work even more effective? Crill said this is the 'Dorothy solution' for CDFIs, i.e., they always had what they wanted, they just didn't know they had it. CDFIs already have the trait that was essential to our success – high touch, understanding the business, working with late payments.
- **Liezl Van Riper** from **Kiva** said KIVA Zip enables small businesses to crowdfund $15,000 at zero interest, zero fees. Now in their 3rd year, with a high growth rate, KIVA Zip has reached 45,000 lenders with loans as little as $5 and have fully funded their 1,000th borrower. This is purely character-based lending. Rather than looking at credit scores, they ask, is there a person in that community who vouches for that borrower? If so, they look carefully at the accuracy of materials before putting them up on the Kiva website. The majority of borrowers are people of color; the average income is $38,000. This is Kiva's target borrower audience. Van Riper said that missing in this conversation is the first rung of the credit ladder. Where is the $5,000 starter loan that enables borrowers to prepare themselves for larger lines of credit from more established lenders? That's where KIVA Zip comes in, working with Accion and Grameen.
- **Susan Koehler** of **Sam's Club** said their Giving Program supports the DreamFund and AEO's TILT Forward initiative. As a new funder, it's been helpful to learn how they can make a difference in microenterprise – to hear about experiments, what's working, what's not, what combination of stakeholders is required to get this right. New models are both necessary and hard. Through the TILT Forward initiative, AEO can focus on testing and scaling product marketing and capital products on behalf of mission-focused

lending institutions. Sam's Club started with OnDeck as one experiment and looks forward to more experiments with people in this room.

- Joyce Klein observed we're at a place in the CDFI lending market where CDFIs have to figure out what they do well and create new business models out of it that relate to the value we're able to provide. Changes in marketplace make this even more imperative. Think about scale and impact that goes beyond direct high-touch lending, to policy, regulation, and other collaboration. This is a big and exciting challenge that depends on organizational leadership skills in leadership and management. What is strength of a CDFI's leadership and management team and its ability to manage change and be innovative? How do we build that part of the industry and use this leverage point to take us to another place?
- **Dan Nissenbaum** from **Goldman Sachs** shared a number of thoughts.
    1. CDFIs shouldn't see this as a binary competition, "either online does it or we do." It's been clear today that this push towards collaboration and partnerships makes sense. We should create an ecosystem map / flow chart of how small business loans are funded in the online space and with CDFIs.
    2. Where does subsidy go? To the organization (CDFI) or to the loan (online)? This is an interesting question.
    3. Goldman Sach's 10,000 Small Businesses program has a portfolio of 30 small business lenders. They see both CDFIs that want to hold on to loans and CDFIs that want to sell. He is not sure they understand cost of holding the loan, including high-touch servicing, reserves, and losses. Is there a CDFI that is as profitable with a referral model?
    4. Management education is important. We also have a business training program and then access to capital at the end. Many people come into an education program thinking they need a loan but realize they don't.
    5. Can the CDFI Fund direct money to be more incentive-based? Banks' movement away from small, unsecured funding will be disruptive and challenging.
- Kassar asked if CDFIs can qualify for CDFI Fund money if they sell their loans. "Does that put you in jeopardy?" Dolan said that, as soon as CDFIs start originating for someone else or originating with the intent to sell, the asset becomes what investors focus on. The origination migrates to investor priorities, not the CDFI's mission orientation, even if CDFIs retain servicing.
- Rohan Mathew wants to create a credit scoring system to assess risks below 625 FICO. The business model requires quick, automated screening – but overreliance on a credit score proxy eliminates our target communities, especially people of color. Can we create something more inclusive of communities we're trying to serve? How can we use existing systems to mine data we already collect?
- Frank Altman offered a few helpful analogies.
    - Supermarkets rentl shelf space. They're not making the food; they're making a platform for purchases.
    - Self-sourcing: using phone to buy airplane tix. Al Gore said this was the biggest job killer in the U.S. It costs Delta a fraction of a cent, for an incredibly complex, secure system.

- Smart grid and capacity-leveling. Tesla is doing this with connected batteries. In our situation, there are groups with loans and groups with cash. Can we create a 'CDFI R+D lab' consortium that considers models to see if they have legs? Can we draw on the Carsey database with transaction data? (Swack noted their industry analysis for the CDFI Fund found strikingly low deployment rates.)

- **Jack Northrup** said that 90% of CDFIs have less than $5 million, which is not a sustainable business model. If CDFIs can get off the grant cycle and become self-sufficient, the social mission can take care of itself. (Swack noted that more CDFIs are starting to merge, based on discussions with small and emerging CDFIs.)
- **Steve Brookner** from the **National Cooperative Bank** said that their objective is to get capital into hands of small businesses, and they use CDFIs as a mechanism. However, many CDFIs don't deploy effectively and/or their default rates are high; they don't have sophisticated systems. Movement should be towards specialization of CDFIs, with support from funders. The National Cooperative Bank's CDFI Assistance Program incentivizes partnerships between those who originate, but don't have capacity to underwrite and service.
- **Rachel Maxwell** of **Community Sourced Capital** said that technology does not equal innovation. It's a tool for innovation, a tool for driving what we do well.
- **Charlene van Dijk** from the **CDFI Fund** expressed her personal opinion that we should think about regulating disclosures to borrowers in the future. Rohan Mathew baked interactivity into The Intersect Fund's loan closing. Can we have a disclosure like that, instead of regulatory legalese?
- **Jim Baek** from **Deutsche Bank** posed two pieces of 'pre-work' for follow-on activities:
  - In disaggregating the CDFI value chain, what is the pricing for those various aspects, e.g., sourcing, underwriting? Then one could apply the appropriate fees.
  - What is the overlap in terms of customers and clients? Customer profile, geography, etc.
- Kassar reiterated, "We don't know how to use you guys (at least I don't) even though we have a similar mission. There are probably opportunities that our borrowers are missing out on – but, to be a part of online lending, you need to understand how to work with us who are attracting borrowers online. We'd love to use you, we just don't know how."
- Catarah from Southern Girl Desserts said, "You guys do great work, but where are you? It took us two years to find the Opportunity Fund, and that piece of direct mail almost went into the trash. You need to use the Internet. There are people in the community where we work who don't trust a lot of people. Come to a community forum or other trusted venue. Our businesses are on social media and out in the community. There are a lot of distractions. You guys are there, but it's like, 'Where's Waldo?' We can't find you but we need you."
  - Shoneji Robison suggested forming relationships with realtors or landlords to connect with small businesses on the front end, when tenants are coming into spaces. Their business is located inside a mall.

- Brian Najbararda said it was humbling to hear that conversation about scale has been happening for a number of years and encouraged us to continue these important questions.
- Eric Weaver said that CDFIs have been reluctant to rely on someone else's underwriting, but that other lenders do it all the time. The Opportunity Fund did it for the first time with a for-profit microlender in Los Angeles, making larger loans to their graduating clients. It was scary but it worked. For those serious about collaboration, look for a way to rely on someone else's underwriting.

Joseph Firschein of the **Federal Reserve Board of Governors** delivered a few closing thoughts. Speaking for many in the room, he noted that remarks by Ami Kassar and Southern Girl Desserts was a wake-up call; we think we're out there and everyone knows us, but we're less known than we think we are. He wondered what the CRA implications are for bank activity in this space and wants to drill down on SBA innovations. Citing Harman, he agreed that the question is not if CDFIs should change, but rather how, and encouraged us to avoid false dichotomies. In the 'wild west,' there is no ability to shop and compare on common terms. Are alternative lenders reporting to personal and business credit bureaus, or should they be? He pointed to interest by large technology platforms and players to partner with CDFIs and mused, "Buy, build, or a combination?" At the end of the day, we have to avoid people being lent too much money at terms that harm their business.

Moving the 16th annual Financial Innovations Roundtable to a close, Swack noted that we've learned that CDFIs doing tremendously innovative things, including promising new partnerships. But it's also clear that quality control, transparency, and a host of other issues need to be addressed in the 'wild, wild west' of online and alternative lending. We must collect and analyze data so that we understand what's working well and for whom. How do we achieve scale while also maintaining our mission? Since even larger, sophisticated CDFIs rely heavily on subsidy, how do we effectively use subsidy? To quote John Berdes of Craft3, "Impact isn't free."