LIPAM International

CONFIDENTIAL DRAFT

MICRO AND SMALL BUSINESS FINANCE IN THE USA:

A STRATEGY FOR STRUCTURAL AND POLICY CHANGES IN THE SECTOR

Ira Lieberman, Jose Ruisanchez, Paul DiLeo, Jenifer Mudd,
Keith Catanzano and Alana Heath

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In addition, we would like to thank the many individuals who were kind enough to give up their time and allow members of our team to interview them over the past four months. The list of interviewees is in the back of the document.

Overview

Introduction

The American Dream is out of reach for millions of Main Street and micro business owners. Yet there is cause for optimism: Technology is making it possible for new providers to deliver capital to Main Street in new ways. Automated credit decisions that aggregate and analyze a wide array of contextual data as well as peer-to-peer lending and its corollary, crowd-funding, are fast becoming the norm. In parallel, post-crisis performance pressures mounting within the traditional worlds of banking, community development finance and philanthropy are pushing leaders in each discipline to explore new models for investment and capital formation as well as product distribution and development.

Against this backdrop, AEO, the national trade association for US microfinance, asked Ira Lieberman, one of the pioneers in enabling microfinance to scale internationally, to assemble a team of experts to answer the question, "What investments in infrastructure and capacity are required to ensure that mission-focused lenders and service providers remain relevant and achieve sustainability in the United States?"

At the same time, AEO asked Mitch Jacobs, a serial entrepreneur with a long track record of serving Main Street, to Co-Chair the Micro Capital Task Force (MCTF), a systematic and coordinated effort to bridge the emerging and established elements of the U.S. financial system in order to solve the gap in loans <$250K. The MCTF represents all of the stakeholder groups that must engage to advise Treasury and the White House.

This meeting represents the intersection of AEO's priorities: Moving money to Main Street and ensuring that mission-focused lenders and service providers are prepared to do their part.

Our time together on 19 February will shape and inform a path forward for the Micro Capital Task Force. We will also use some of the time to test a framework and initial hypotheses for the MCTF working groups in order to continue engagement with a broader group of stakeholders.

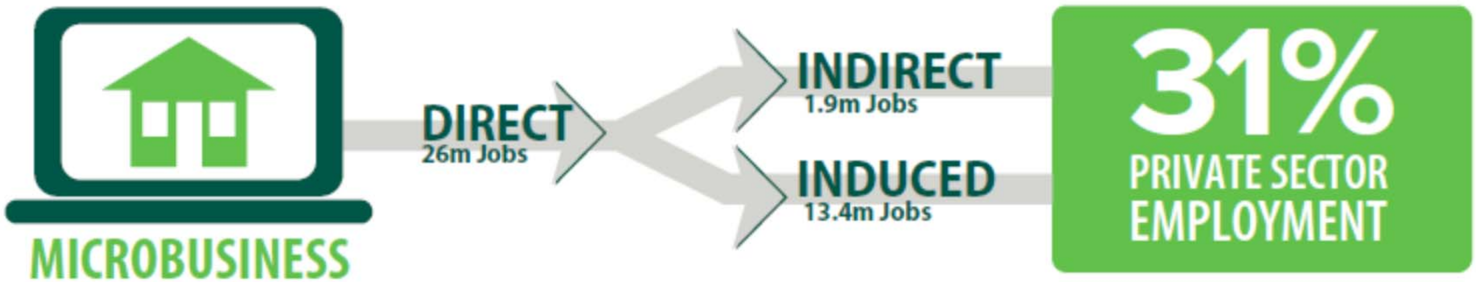
Following this meeting, AEO will continue to engage with each of you and others as we support the conveners of the MCTF Working Groups. This entire process is expected to culminate in formal recommendations to the Department of Treasury, the White House, and Congress in June.

Primary Objectives of the Strategy

1) Support disadvantaged populations
2) Provoke micro and small "Main Street" business growth and new jobs
3) Generate a culture where access to finance is more readily available at sustainable interest rates

The CDFI industry needs to be re-structured to perform with much greater efficiency and sustainability

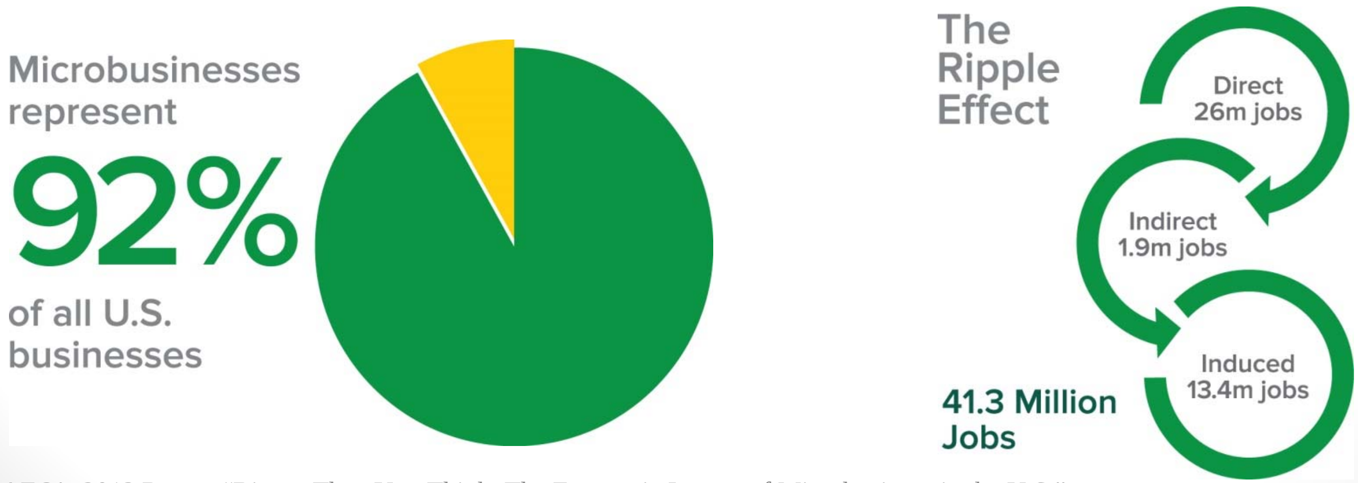
Who is Our Target Client?



"Main Street" businesses are defined as the combination of two categories that focus on the underserved:

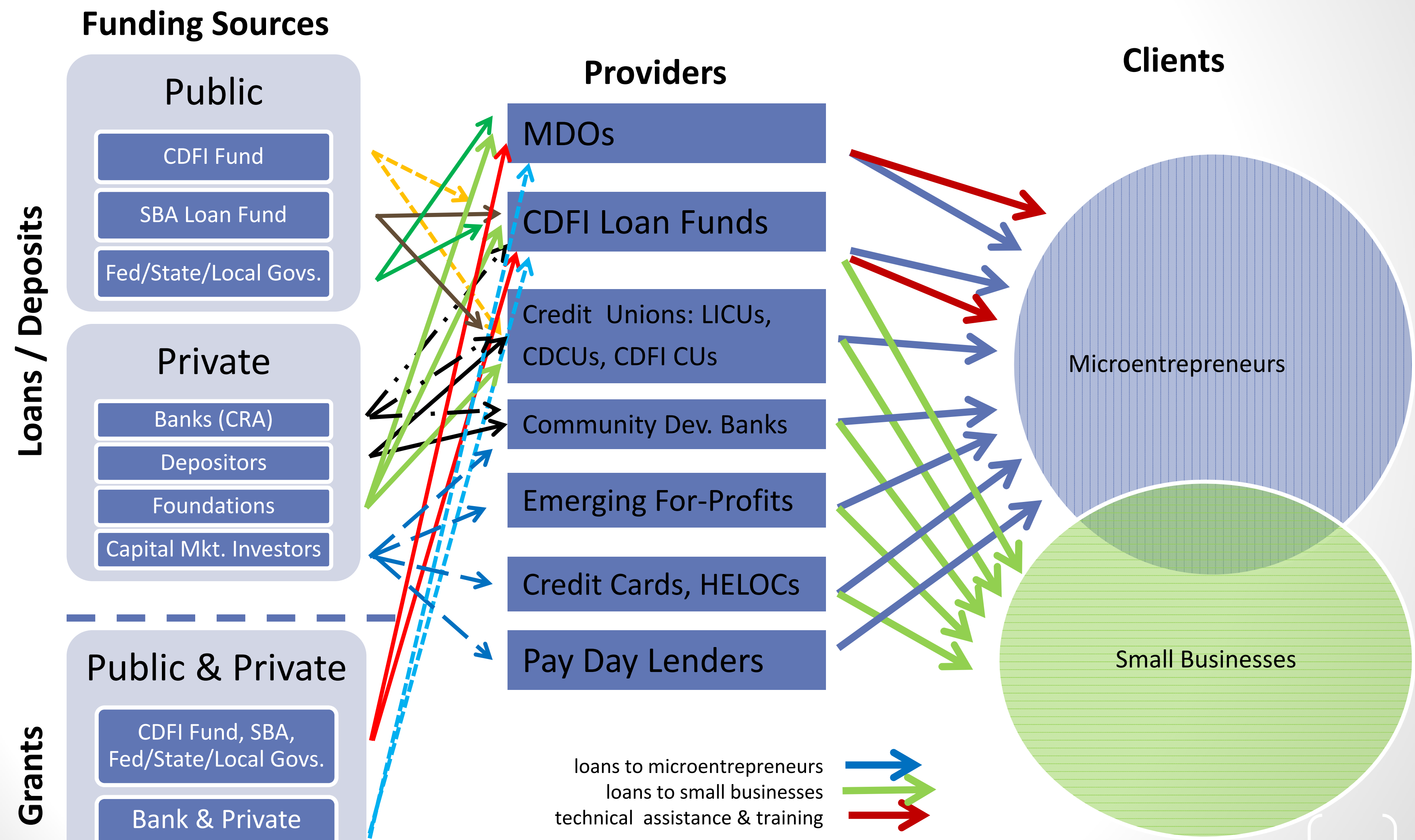
1) Micro businesses (0-4 employees needing up to $50k in financing)

2) Small businesses (5-20 employees needing up to $250k in financing)



Source: AEO's 2013 Report "Bigger Than You Think: The Economic Impact of Microbusiness in the U.S."

Main Street Lending in the U.S.



Source: Lieberman, Ira, Phil Goodeve and Jenifer Mudd. *U.S. MICROFINANCE AT THE CROSSROADS: Scale and sustainability: can lessons from international experience help guide the U.S. sector?* September 2012

Conclusions

Conclusions

- **Who is the Industry Serving and Why**
  - Micro and small businesses represent over 90% of business establishments in the U.S.
  - A vibrant micro and small business community is critical for disadvantaged populations and communities
  - Critical for dynamic job growth and for closing the wealth gap
  - More robust infrastructure support for Main Street businesses, including financing and business development services, can significantly improve the prospects of the disadvantaged
- **Large Unmet Funding Gap**
  - Though there is inadequate industry data, the use of credit cards, the emergence of merchant advance lenders, predatory money lenders and other newly emerging for-profit lenders, suggests that there is a large unmet need
- **Inadequate Industry Data**
  - There is no ability to determine on an industry-wide basis whether funds in the sector flow to deep seated areas of poverty or disadvantaged populations
  - No comprehensive database for the industry
  - To engage larger and more diverse funding sources significant improvements in industry data are required

Conclusions

- **Community Development Financial Institutions**
  - **Loan Funds** as NGOs focused on microfinance and small business with very few exceptions have:
    1) Failed to scale to meet demand
    2) Have complex business models
    3) Are too costly to operate without substantial subsidy. As structured the sector falls short of the need.
  - **Credit Unions** have significant potential to serve micro and small business, but are essentially focused on other loan products.
  - **Community Development Banks** have substantial potential to serve Main Street business and are receiving substantial funding from the Treasury through SBLF ($30b fund)
  - There is an urgent need for structural and policy reform in the sector.

Conclusions

- **For-Profit lenders are leading the way in technology and data mining to promote scale**
  - There are a number of for-profit, privately owned financial intermediaries, that are addressing the needs of the micro and small business sector
  - They are focused on scale-outreach, agility, quick response to credit requests, and profitability via a variety of models and interest rates that vary greatly
  - This is “disruptive” technology and a few private for-profit lenders have already eclipsed CDFI Loan Fund scale
  - A few CDFI Loan Funds are beginning to awaken to the potential of technology to change their model and improve efficiency
  - Without technology adoption by a network of CDFIs (and it cannot be done CDFI-by-CDFI) the CDFI micro credit industry will increasingly lose relevance

Conclusions

- **Business Development Services**
  - BDS plays a critical role in the promotion of small and micro business
  - BDS data is inadequate and provides little evidence of impact
  - There are no generally accepted metrics
  - There is significant duplication in preparing BDS materials
  - While recognizing the importance of “high touch” community presence there is substantial scope for utilizing standardized materials facilitated by technology
  - Potential to enhance efficiency and productiveness by partnering with financial institutions

- **Interest Rate Culture**
  - For CDFI Loan Funds to be relevant, they have to charge interest rates consistent with sustainability of an efficient operation
  - A deep seated culture of subsidized rates is impeding the industry
  - Cost recovery interest rates are not incompatible with social mission

Recommendations:
Access to Credit for Main Street

Goals: The Vision for the Industry

Our vision for the industry includes dramatic scaling-up (500%) over the next 5 years and providing support for the creation of 30 investible institutions which will attract private sources of capital to augment existing public sources of capital and CRA credit provided by commercial banks. This will require joint venture operations between CDFIs and technology providers, as well as support from independent BDS providers.

- Increase the scale of micro and small business lending by 500% over 5 years
- After 5 years have a set of up to 30 investible institutions in the sector that are able to attract substantial private capital while remaining committed to micro and small business sector
- Bring private debt and equity capital into the sector through privately managed investment funds
- Provide capacity building support and a vision for these institutions
- Require independent, third party ratings and create an integrated data platform for these institutions
- Fully integrate and exploit emerging technologies to achieve scale and lower operating costs
- Attract for-profit financial institutions that are scaling on the basis of data mining and new technologies
- Identify anchor investors for the program, starting with the CDFI Fund as a basis for attracting a wide range of private investors

Overview: Recommendations

1. Create CDFI Fund complementary funding window for Main Street businesses
2. Establish privately managed investment funds
3. Promote interest rates that cover costs of operations
4. Launch technology support program
5. Develop comprehensive, integrated data platform
6. Coordinate on-going capacity building program for sector
7. Enhance business development services

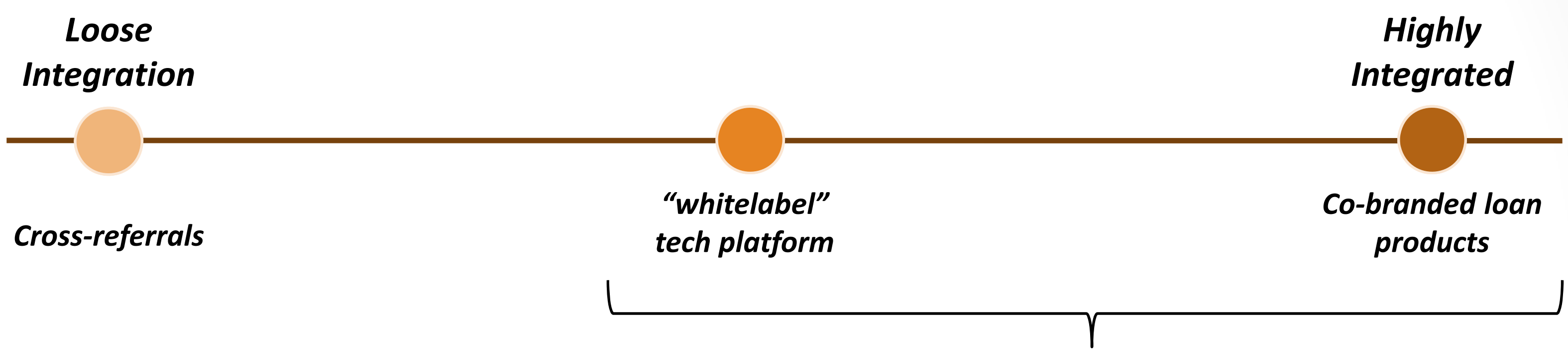
Create a Funding Window within the CDFI Fund

- The CDFI Fund at the U.S. Treasury should work with AEO and others to create a complementary funding window to focus a set of awards on 15-20 CDFIs (Loan Funds, Credit Unions, Banks and For-profits) that commit to scale up their support to micro and small businesses

  - ➢ The program should be a five year program with capacity building, multi-year grants of up to $2 million provided to these institutions

  - ➢ Selection would be by competitive application process—selection criteria should be totally transparent
    - ✓ Be rated/evaluated by CARS
    - ✓ Each of the institutions should then report quarterly financial and operational results to CARS electronically.
    - ✓ To report at a detailed level showing outcomes -- number of micro and small business loans and social impact, such as the number of jobs created by key demographic and geographic categories that can be evaluated
    - ✓ Participating institutions should be encouraged to evaluate private sector technology institutions so that they can lower the cost of underwriting and improve their timeliness in granting credits. Joint ventures between CDFIs and private sector technology institutions should be considered as part of the grant screening criteria
    - ✓ Linking BDS providers to the program should be encouraged and also be part of the grant screening criteria

There are multiple levels for alternative, online lenders to integrate products and/or services with community lenders.



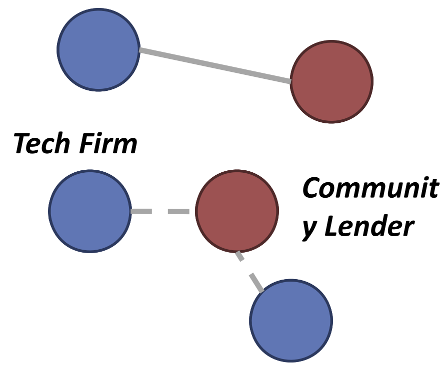
•Community lender refers borrowers to alternative lender – may pre-negotiate some aspects of loan product.

•*Easy integration but low value to borrower & community lender.*

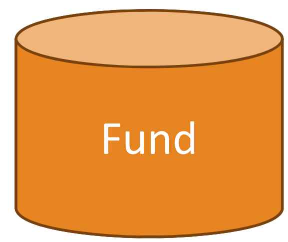
1. **Partnering around customer acquisition and customer management.** Create co-branded loan products combining credit technology for scale and convenience with "high touch" relationships
2. **Product licensing.** An intermediary assesses alternative lender's products, licenses the product and make it accessible to the CDFI network.
3. **Partnering to increase the credit-worthiness of the small business borrowing pool**. Offer targeted business development services to declined borrowers…increases their credit worthiness and lenders' customer pool.

Expand partnership of technology firms and community lenders by offering low-cost capital.

Self-organize into partnerships…[1]



…access low-cost capital from privately managed loan fund.



<u>There are many models for partnership between community lenders and tech-companies to build on…</u>

- *Integrate technology as part of community lender's process*
- *Integrate different technology for loan products, as desired*
- *Together identify/license products & strategy/material to go to market*

<u>Streamline the fund's due diligence process to attract more scalable capital</u>

- *Easier to assesses partnerships of Tech-Community Lenders based on defined products and markets*

Partnership builds on alignment of goals (if not mission) to combine unique characteristics of each group.

(1) CDFIs and tech companies may not "naturally" partner because of culture and/or the fragmented structure of the CDFI industry. In this case, an intermediary could vet the alt. lender's products and make them accessible to the CDFI network.

Continued: Funding Window within the CDFI Fund

- The SBA, CRA lenders and foundations should be encouraged to join the program so that adequate financing is available to organize the program and for portfolio expansion
- A set of incentives should be created to monitor performance by participating CDFIs – to account for additions and drop outs from the program. Institutions which are 10% or more behind their proposed Business Plan for micro and small business lending during the first two years of the program should be dropped from the program. Institutions that are 15% or more ahead of their own projections in any given year should be eligible for additional CDFI Fund funding if they have not reached the maximum of $2m.
- The Program should consider additional institutions in year three
- The program should be evaluated after year three
- The program should begin on January 1, 2015

Privately Managed Investment Funds

- Treasury should also promote an indirect channel of capital through privately managed investment funds
- Treasury should provide anchor investment to these privately managed funds selected through a competitive process which would heavily weight their ability to raise matching capital
- These investment funds could take on management of the complementary fund window of 20 and up to 30 institutions (approximately 10-15 institutions per fund)
- Fund managers would operate under normal fee arrangements and incentives
- Funds should include a dedicated technology-focused equity fund to promote emerging technology intensive solutions to scale and cost
- Selection criteria for all fund managers would include the following:
  - Demonstrated track record in social and impact investments
  - Demonstrated ability to attract capital
  - Operating within a viable asset management firm
  - They agree to report their financial and operational results to Treasury through CARS to be kept confidential
- At the end of 5 years there would be 3-4 fund managers managing a range of debt and equity vehicles mobilizing private capital to the sector

Continued: Privately Managed Investment Funds

- International microfinance found that professionally managed investment funds bring several benefits:

  - Combines the full range of capital providers
  - Devotes the scarcest grant capital to its highest and best use
  - Encourages management to adopt solid business practices
  - Ensures long term viability in the mix of products and services offered
  - Provides for rigorous governance
  - Brings a wider range of expertise to support and guide management

Promote Interest Rates to Cover Costs of Operations

Based on recommendations from our research and from FIELD the following actions pertain to pricing:

- Microlenders need to develop a clear pricing strategy, including a rationale for their rates.
- Funders should consider whether their expectations with respect to a program's scale and sustainability are reasonable and consistent with rates being charged.
- The industry should support market research that could illuminate pricing sensitivity.
- The industry should promote pricing transparency rather than placing restrictions on pricing

Source: Lieberman et. al. *Microfinance at the Crossroads.* 2012

Create an Integrated Data Platform

- **Integrated Data Platform.** The Treasury and other funding institutions such as SBA and CRA lenders and the various associations should support data collection, analysis and reporting to the CARS Platform so that a data facility such as the MIX Market can be replicated as appropriate.

  - The CARs Platform has already been created and the second stage launch will occur in the 2nd quarter of 2014 so that data from other sources could migrate over the course of the year.

  - CARS would also need to be available for ratings, reporting, and data analysis for the new complementary fund window for 2015.

  - Funding for start-up, data acquisition, etc. should be provided by the Treasury, foundations, CRA lenders and their foundations.

  - CARS will charge for its services so that the data platform operates on a self-sufficient basis after year three.

Build Capacity for Sustainable Institutions

- Continuous capacity building and training for the sector is essential for realizing the vision and goals

- We recommend that AEO coordinates a capacity building program for the sector, focused on senior management of CDFIs, through the Boulder Institute (BI) based at the Maxwell School of Public Policy at Syracuse University.
  - This capacity building program should be focused on the complementary funding window institutions
  - The existing Boulder program should be open to CDFI management and senior staff in 2015.
  - A one or two week complementary program, coordinated through AEO and Treasury should be required for up to 30 institutions joining the Main Street funding window by 2015, timing to be decided.
  - The start-up of Boulder for the U.S. Industry should be funded by the Treasury, CRA lenders and foundations for three years; thereafter, it should operate on a self-sufficient basis.
  - Boulder charges a fee for its three week, in-residence program. Historically donor institutions have provided scholarships to support many of its students. Ideally that practice will continue in the U.S.

Business Development Services

- We recommend that the Treasury, supported by other funders, support the creation of a "Platinum Grant" facility for 15-20 BDS providers in year 1, rising to as many as 30 by the end of year 5;
- Grants would range up to $1.5 million per year for 5 years based on the scope and performance characteristics of the BDS provider.
- BDS providers would form a virtual network which would scale-up their operations, increase their level of sustainability, force their innovation and represent emerging good practice in the sector.
- The facility would be awarded to independent BDS providers or those part of CDFI Funds which operate as a separate business unit; and particularly to BDS providers who partner with CDFI Funds;
- Applicants would be independently evaluated on a variety of criteria;
- Funding would be available for BDS institutions proposing innovative pilot programs or the adoption of new technology to increase the effectiveness of their outreach to clients;
- Those BDS providers which lag their projections by greater than 10% or more at end of year three would be required to drop out of the program;

Continued: Business Development Services

- BDS firms which are part of the facility would be expected to report performance vs. agreed metrics every quarter for the first three years and thereafter every six months;
- Program would be evaluated at end year three;
- The facility would support the development of tools/apps to facilitate dissemination of BDS materials;
- Capacity building and training for senior staff of the BDS providers to create a shared vision of the BDS network;
- The facility would create a data base or platform shared in the Cloud so that network members could showcase and offer the sale of their programs/ curriculum (a la Apple App Store or Amazon);
- The facility would provide members with up to date knowledge on emerging technology to enhance program content and delivery;
- **AEO would have a role in the governance of this facility.**