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Articles

Character Based Lending: A Practical Model to Enhance Access to Capital

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Most financial institutions use a potential borrower's credit score as a proxy for the borrower's character. For many potential borrowers, especially those representing underserved communities, a credit score may not be an accurate measure of character and often has little to do with whether a borrower will repay a loan. This emphasis on credit score excludes many worthy borrowers from having access to the capital they need. Colorado Lending Source, an economic development organization in Colorado, developed a successful "character-based" loan program through which they provide startup and growth funding to borrowers that would not be able to obtain affordable capital elsewhere.

INTRODUCTION

Most traditional lenders, namely banks and credit unions, use five criteria when making lending decisions: character, capacity, conditions, capital, and collateral. To obtain traditional financing, a potential borrower must check each of these "boxes". Additionally, most traditional lenders will not lend to businesses that have been in existence for less than a minimum period of time: usually 2 or 3 years. Moreover, while there was a time when lenders assessed "character" based on the relationship between the banker and the borrower, today most financial institutions simply use a potential borrower's credit score as a proxy for the borrower's character. For many potential borrowers, especially those representing underserved communities including individuals who own businesses in rural or low-income urban areas and woman or minority owned businesses, a credit score is not an accurate measure of character and, more importantly, has little to do with whether a borrower will repay a loan. This emphasis on credit score excludes many worthy borrowers from having access to the capital they need to launch or grow a business. To overcome this lack of access to capital for underserved small business borrowers, Colorado Lending Source, an economic development organization based in Denver, Colorado, developed a "character-based" loan program through which they provide startup and growth funding to borrowers that would not be able to obtain affordable capital elsewhere.

THE PROBLEM

Access to affordable capital is one of the main problems facing small businesses and startup ventures across the United States and in Colorado in particular. A number of studies have demonstrated this difficulty in obtaining startup or growth capital by small and medium enterprises (Collis et al., 2013). According to the Federal Reserve's annual Small Business Credit Survey, over half of small businesses that applied for a loan in 2018 could not obtain the financing they sought. Financing shortfalls were particularly pronounced among firms with weak credit profiles, younger firms, and firms in urban areas. Firms seeking $100,000 - $250,000 faced the greatest difficulty in obtaining funding (U.S. Federal Reserve Banks, 2019). Moreover, access to capital is also a particular challenge for woman and minority owned businesses as well as businesses owned by low-income or immigrant entrepreneurs. For example, year-to-date of as of August 30th, 2019, 14% of Small Business Administration 7(a) and 10% of Small Business Administration 504 loans went to women owned businesses while women owned businesses account for roughly 40% of businesses in the United States (U.S. Small Business Adminstration, 2019). Similarly, a national study regarding access to capital for minority loan applicants found that such applicants were denied at twice the rates of white applicants (Cavalluzzo & Cavalluzzo, 1998) while other studies suggest low income, minority, and immigrant entrepreneurs often lack assets or savings that can serve as collateral for small business loans (Lee, 2019).

Part of the reason for this lack of access to capital results from the underwriting process employed by most traditional lenders, which stems from the highly regulated nature of bank lending. These lenders, typically banks and credit unions, have strict underwriting criteria based on the "5 C's of Credit": character, capacity, conditions, capital, and collateral. These lenders require that potential borrowers meet a particular ratio of collateral to loan amount, have minimum credit scores (as a proxy for character), inject a certain amount of capital relative to loan amount into the project, and, usually, require that a business have already been in existence for at least 2, and sometimes 3, years. Large, geographically dispersed banks, in particular, rely on credit scores when making underwriting decisions while community banks have a somewhat greater degree of flexibility in look at an applicant's character (Kahn et al., 2003). Many startup businesses and businesses created by members of underserved communities simply cannot meet these criteria.

Given the lack of access to traditional lending sources, small businesses, particularly those identified as not meeting the 5 C's loan criteria, have limited options in starting and then growing their business. Alternative lenders, like Community Development Financial Institutions ("CDFI's"), provide credit to small business borrowers where one, or on occasion more, of these elements are not satisfied. These lenders, however, typically require their loans to be fully secured which, in and of itself, acts as a bar to potential borrowers from underserved communities as people from these communities often do not have the assets to fully collateralize a business loan. Additionally, government agencies, like the U.S. Small Business Administration and U.S. Department of Agriculture, provide credit enhancements like guaranteeing repayment of a portion of the principal of a business loan, which reduces risk to lenders and allows them to relax their underwriting criteria, or provide direct lending themselves. In making their underwriting determinations, however, regarding the "character" component, both traditional lenders and alternative lenders tend to focus on an applicant's credit score as the sole or primary measure of the applicant's character. Higher credit scores have been shown to decrease loan denial (Cassar et al., 2015). "Character", i.e. credit score, tends to be a particular hurdle for "underserved communities", for example minorities, women, disabled, veterans, owners of startups and businesses located in rural or distressed urban communities, as a result of lack of credit history (Lee, 2019).

Another, more recent, addition to the small business lending landscape are online lenders. Some of these lenders do provide capital to borrowers with less than stellar credit scores. They do so, however, at interest rates that range from challenging to usury to unconscionable. These loans are often coupled with inappropriate terms like having payments drawn from a borrower's account on a daily or weekly basis with interest charged at each withdraw. Many online lenders also make it inordinately difficult for a borrower to extricate itself from the arrangement, often charging exorbitant fees even when a borrower is paying off a loan in full.

As such, an modified model for small business lending was needed. One that more effectively allowed a lender to evaluate a borrower's character. "Character" has been described in numerous ways including integrity, trustworthiness, and degree of relevant experience (Lee, 2019). In the end, this character evaluation really boils down to two questions, the answers to which are based on the assessment of the borrower's character: (1) how likely is the business to be successful and (2) if the business is not successful, how likely is the borrower to repay the loan? Colorado Lending Source's character-based loan program, the Colorado Main Street ("CMS") program, reimagines the 5 C's analysis and offers loans to borrowers based on the answer to those two questions.

A NEW APPROACH TO DETERMINING CHARACTER

Colorado Lending Source ("CLS") is a mission based nonprofit economic development organization whose mission is to "foster the economic growth of diverse small businesses within [its] communities." To achieve this mission, CLS chose to focus on assessing the character element of its applicants by developing a robust "character based" underwriting process that allows them to engage in a rigorous assessment of the character of a potential borrower rather than being forced to rely primarily on credit scores. This character assessment, in turn, allows CLS to reduce risk by assessing the borrower's business acumen, his/her passion for the business, and the likelihood that the borrower will repay the loan even if the business ceases operating.

The underwriting process takes place in 4 or 5 stages depending on the age of the business. For start-ups or businesses less than two years old, CLS asks an applicant to move through a "Pre-Application Review" conducted by their Small Business Support Officer ("SBS Officer"). The applicant submits a business plan and monthly cash flow projections for the next two years along with assumptions prior to filling out a full application. Once the SBS Officer is satisfied with those documents, or if the business has been in existence for longer than two years, the borrower prepares a loan application and submits financials for the business. Once a loan officer determines the application is complete, the applicant participates in a 30-minute interview with an internal loan review committee ("ILRC") composed of CLS staff. The ILRC is tasked with assessing the applicant's character and preparedness. If the ILRC votes to move forward with the application, a loan officer performs formal financial underwriting on the loan application, which is similar to that performed by a traditional lender. Then, if the loan officer determines that the project is financially viable, the loan officer presents the loan package to an external loan review committee ("ELRC") composed of bankers, economic development professionals, and others. If the ELRC votes to approve the loan, the loan closing process begins, and funds are subsequently transferred to the borrower. This multi-step step process, described in more detail below, has resulted in a surprisingly low default rate among CMS fund recipients.

CLS's CMS application is unique. The intent behind the application is to provide insight into the character of the borrower and the borrower's preparedness to receive a small business loan. As such, in addition to more traditional questions, the loan application includes questions like:

- "Please tell us how you plan to use the loan funds you are requesting."
- "Where will the funds you are investing in this business come from?"
- "If your business is just starting out OR is less than two years old, and you have never owned your own business before, what have you done to help prepare to be a small business owner?"
- "Why are you in business / Why do you want to own your own small business?"
- "What is the 'Statement of Purpose' for your business

AND what problem are you solving?"
- "What type of business culture have you created / will you create for your employees?"
- "Who is helping you with your business? Do you have a mentor or trusted advisor not involved in the day-to-day operation that you can talk to if you have questions about your business?"
- "How will you be handling your bookkeeping and record-keeping? What accounting system or program will you be using to keep track of income and expenses?"
- "Why are you / will you be successful with your business?"
- "How will you repay Colorado Lending Source if you aren't?"

Each of these questions helps to assess the character and readiness of a small business borrower. In particular, questions relating to resources used to prepare for small business ownership, why the applicant is in business, and culture all provide insight into the character of the borrower. Questions relating to use of funds, where the borrower's fund come from, the statement of purpose or problem solved, the existence of a mentor, and how bookkeeping will be handled provide a measure of readiness. Asking the applicant how the loan will be repaid forces the borrower to consider the worst case scenario and ensures a backup plan is place. Finally, in total, the degree to which an applicant thoughtfully and thoroughly completes the application is, in and of itself, a telling measure of the applicant's character.

Additionally, as part of the loan application, an applicant is required to submit a letter of recommendation attesting to the high quality of the applicant's character. This requires an applicant to find someone who will not be involved in the day-to-day operations of the business and who is not related to the borrower who is willing to put his / her name and reputation on the line in support of the applicant and is a strong alternative to measuring character on the basis of credit scores.

Along with the written application, a borrower must provide a written business plan, monthly cash-flow projections, and assumptions. Each of these documents also provides insights into the borrower's character and readiness to receive a small business loan.

After submitting the written application and accompanying documents, if the loan officer reviewing the file is satisfied with the content and quality of the application, the potential borrower moves on to the ILRC interview. This is a ten-minute presentation by the applicant to a committee composed of CLS staff from across the organization followed by a roughly twenty-minute question and answer session. Importantly, all departments within the organization are represented on the ILRC, which provides a diversity of perspectives as to the viability of the project. The ILRC presentation is an opportunity to look the borrower in the eye, as it were, and to judge the veracity, passion, persistence, and other relevant characteristics of the applicant. How the applicant responds to questions, how prepared they are, and the degree of subject matter knowledge they possess are all factors taken into account by the ILRC. At the conclusion of the presentation and Q&A session, the ILRC members are polled as to whether the loan application should be allowed to move forward. Two thirds of the members must vote in favor for the application to proceed.

Once the potential borrower is approved by ILRC, the application moves through formal financial underwriting by a loan officer, which is an analysis of application documents.

At this time, personal credit scores are obtained for any individual who owns more than 20% of the business. Importantly, and uniquely, if there are any blemishes on the report, CLS allows the applicant to provide an explanation of their credit score and the opportunity to remedy any past due accounts. If the explanation is deemed reasonable and not reflective of poor character, a poor credit score won't preclude the applicant from obtaining financing.

The loan officer also performs a global cash flow analysis during which the loan officer uses information from historical personal tax returns, a personal financial statement(s) and the personal credit report(s) to understand the business owners' personal income as well as obligations. This information is combined with the business's historical (if applicable) and projected income and expenses and the loan officer determines if the business and owners can meet their financial obligations, including the proposed loans, on a "global" basis.

If the business is an existing business (i.e., at least two years old), the loan officer performs a balance sheet analysis, spreading annual and interim balance sheets, then makes adjustments based on the proposed transaction (new loan and borrower's equity injection) to create a pro-forma balance sheet. In narrative form, the loan officer analyzes the balance sheet, comparing it to Risk Management Association (RMA) industry standards for a business of the same type and size. If this information is unavailable, a note is made in the file. The loan officer also analyzes liquidity ratios, debt-to-worth, and pro forma working capital.

The loan officer then conducts a profit & loss analysis, spreading historical, if applicable, and projected income statements to see profits/loss in each period, and analyzes revenue generation as well as expenses to understand profitability (or explain losses). Historical and projected profits and losses are also compared to RMA industry averages for a business of the same type & size.

The final stage of underwriting is a cash flow analysis. The loan officer adds back non-cash expenses (i.e. amortization and depreciation) along with other line items as appropriate (i.e. interest expense) to get an accurate depiction of operational cash and factors in existing as well as proposed debt to illustrate cash surplus/deficit and debt service coverage ratio.

Once financial underwriting is complete, the loan officer presents the application to ELRC. ELRC is composed of 12 members who are a mix of lender, economic development professionals, and resource partners. The members serve a year-long term, are trained annually, and meet on an as needed basis. Loans can be: (1) approved, which would then allow the loan officer to issue a letter of commitment and move to closing & funding; (2) declined, after which the loan officer provides the applicant notice of the declination including an explanation of why or; (3) tabled, after which the loan officer is instructed by ELRC to collect additional items and/or answers to committee questions. If the application is tabled, the additional information is then collected and shared with the committee members via email, and an email vote is taken that results in either approval or denial. Prior to each ELRC meeting, members are provided with the financial underwriting analysis, the recommendation letter, and portions of the business plan and/or slide deck from the internal loan review committee presentation.

THE RESULTS

This process has allowed Colorado Lending Source to expand the pool of potential applicants, with 100% of the loans funded under this program going to borrowers that fit within the basket of what Colorado Lending Source considers to be underserved markets. Most importantly, the default rate of borrowers under Colorado Lending Source's character-based microloan program is 3.27% as a percentage of loan dollars funded, which is no higher than that of most traditional lenders.

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