Wells Fargo Works *for Small Business®* Diverse Community Capital Program
Social Capital Knowledge Network

Innovations in Underwriting

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Wells Fargo Works *for Small Business*® Diverse Community Capital: Social Capital Knowledge Network

In 2015, Wells Fargo Bank, N.A. ("Wells Fargo") commissioned a national study to gain deeper insight into the attitudes, needs, and motivations of diverse small business owners related to their use of credit. To accomplish this goal, survey firm Gallup conducted more than 3,000 telephone interviews covering six segments: African-American, Asian, Hispanic, LGBT, veterans, and women-owned businesses. Among the study's findings are that diverse small business owners are more likely than their counterparts in the general small business population to:

- Report having personal credit challenges and be declined for business credit, with African Americans being more likely to not reapply for credit after being declined.
- Have annual business revenues of less than $50,000 and to have a business in the startup and growing stages. As a result they may not qualify for many conventional bank loan products.
- Be extremely or very interested in learning how to build a strong business credit application.

Wells Fargo developed a multi-faceted action plan to address needs identified in the study, and to help more diverse small businesses gain access to credit.

One component of this plan is the Wells Fargo Works *for Small Business*® Diverse Community Capital Program ("DCC") which provides a combination of *financial* and *social* capital to CDFIs committed to serving diverse entrepreneurs. Through the DCC, Wells Fargo has committed $75 million of financial capital to CDFIs across the country with $50 million in loans and $25 million in grants to be disbursed over three years. In addition to financial capital, the program also provides support for a Social Capital Knowledge Network to build effective networks and social infrastructure among CDFIs to increase lending to diverse small businesses. The Social Capital Knowledge Network, designed and implemented by Opportunity Finance Network, includes a variety of capacity building activities for participating CDFIs to showcase best practices, address common challenges, and foster strong networks.

One prominent activity in the Social Capital Knowledge Network ("the Knowledge Network") is the formation of working groups to explore topics of interest to both the participants and the CDFI industry. The working groups allow DCC participants to learn from and connect with those CDFIs in the Knowledge Network making successful inroads in diverse communities, and to document and share those innovations with the CDFI industry. Three working group topics were identified with input from the Knowledge Network participants and based on the strategies outlined in their application to the Diverse Community Capital program. CDFIs signed up to participate in the working group(s) that aligned with areas of strength for their CDFI.

The working groups organized in 2016 covered these topics:

- **Underwriting:** CDFIs are developing new metrics for evaluating the creditworthiness of borrowers with low credit scores and businesses with minimal collateral or equity. They are also analyzing their portfolios to determine the accurate predictors of repayment.
- **Tailored Products and Services:** CDFIs are developing innovative products to serve particular borrower niches and providing technical assistance services to build credit and business skills.

- **Marketing and Outreach:** CDFIs develop marketing and outreach activities that focus on building trust and communicating their value proposition clearly.

This publication is part of a series created for the Diverse Community Capital program that documents the insights and successful strategies of CDFIs to better serve and increase their lending to diverse business owners.

Underwriting Working Group

The conversations among the nine CDFIs[1] that participated in the Underwriting Knowledge Network produced a number of common goals and lessons learned among the CDFIs striving to serve diverse small business owners better. Common goals related to underwriting include:

- *Finding alternative risk models to finance borrowers with thin credit files or poor credit.* Due to their mission and target markets, CDFIs work with borrowers that are likely to have lower credit scores or minimal credit histories. Serving this market means that CDFIs cannot rely on the traditional FICO scores or similar measures to assess the creditworthiness of a loan.
- *Adjusting underwriting criteria to accommodate lack of collateral and owner equity.* CDFIs serve startup businesses, or businesses owned by people with less wealth and financial assets, in greater proportion than conventional financial institutions. The traditional formulas and policies for ensuring "skin in the game" through equity injections and collateral pledges do not work in CDFI markets (and some CDFIs have found that these factors are not the best predictors of repayment in their markets).
- *Updating documented policies and processes to reflect common "exceptions" and CDFI underwriting practice.* CDFIs found that their underwriting policies often required them to make exceptions in order to serve the borrowers and companies that met their mission and goals. Policies that were written to prevent "risky" loans were, in fact, not reflective of the actual risk of CDFI lending activity.
- *Accelerating loan decision-making and improving borrower experience.* CDFIs want to both more quickly approve strong loans and also promptly move borrowers that cannot be approved into referrals for other products or counseling.

While implementing strategies to achieve these goals, the working group members identified common lessons learned in underwriting diverse small businesses, including:

- Innovative underwriting strategies by CDFIs do not undermine risk management or portfolio quality. Rather, the new strategies analyze past and current portfolio activity to inform new practices. They represent a new way of looking at what the CDFI is already doing and aligning its policies with its practices while maintaining asset quality.

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[1] Access to Capital for Entrepreneurs, Bridgeway Capital, Carolina Small Business Development Fund, CommunityWorks, Craft3, Montana & Idaho CDC, Pacific Community Ventures, Self-Help, Wisconsin Women's Business Initiative Corporation

- Efforts to rethink underwriting are not done in isolation. Often, they are part of a larger effort to update the strategic plan, to overhaul other systems, or to more broadly consider the CDFI's capacity and tools to effectively serve its market.
- Improving the borrower experience also improves staff experience. Processes that speed up underwriting minimize the time staff spend writing credit memos. Reconsidering collateral requirements minimizes the documentation required at closing.
- Underwriting innovations are often accompanied by additional targeted outreach, specifically bilingual and culturally sensitive outreach to build trust; and by strategic technical assistance efforts. The Marketing and Outreach working group explored this part of the process in more depth.

This publication spotlights three examples of CDFI innovation in underwriting to diverse communities:

- *Carolina Small Business Development Fund* developed an innovative strategy to support borrowers with limited owner equity. This case study discusses CSBDF's initiative to finance the owner's equity injection for a new loan.
- *Montana & Idaho CDC* dramatically simplified its underwriting policies. The case study describes MICDC's process in condensing 150 pages of underwriting policies to three pages, more accurately reflecting the CDFI's new practices.
- *Pacific Community Ventures* adopted a matrix to streamline its underwriting. The case study includes the PCV matrix that scores prospective loans using criteria to substitute for the measures used by conventional financial institutions, and explains how the CDFI developed and uses the matrix.

Carolina Small Business Development Fund: Equity Capture

When the Carolina Small Business Development Fund (CSBDF) wanted to expand its lending to diverse small business owners, Vice President of Business Lending Amber Banks took a tool from her banker's toolbox and gave it a twist to help the CDFI meet the needs of its potential borrowers. CSBDF provides small business loans and financial training to start-ups and existing businesses along with lending services to community-based organizations in the Carolinas.

After analyzing its lending and borrower turndown history, CSBDF most often saw borrower credit deficiencies in four areas: credit score, collateral, the owner's equity injection, and business management skills. CSBDF's President/CEO, Lenwood Long, challenged the staff to find ways to better serve borrowers who came to CSBDF with one or more of these credit deficiencies.

To tackle an insufficient owner's equity injection, CSBDF developed the "equity capture" loan feature. Modeled after the cash flow recapture tool a conventional bank might use to account for circumstances such as seasonal cash flow, the equity capture feature finances the owner's equity contribution into the business loan. This is structured to provide the business owner with time to benefit from the capital injection; for example, to use the new equipment or to generate sales from a new salesperson before beginning to make principal and interest payments. Then in the second or third year of what is generally a five-year loan, the borrower will pay additional principal payments (usually each quarter), equal to the required 10% owner injection.

The timing helps a borrower who does not have sufficient upfront equity to invest in the business at the start of the loan, and repay when the business realizes increased cash flow from the investment.

Having launched the product in summer 2016, CSBDF considers loans for which to use equity capture on a case-by-case basis and is tying the new feature primarily to its microloan ($50,000 or less) lending. While all loans are eligible for consideration, CSBDF uses equity capture only with loans that have an insufficient owner equity contribution but are otherwise sound in credit, collateral, and business skills.

In the short history of the equity capture feature, CSBDF has identified two challenges and lessons:

- The Small Business Administration will not accept loans structured with the equity capture for the Community Advantage guarantee program, so the CDFI is not able to offer that federal guarantee tool in conjunction with the product.
- It is critical to be clear with borrowers, and make sure they fully understand that the initial payments on the loan will rise in a year (or two years).

Amber Banks sees that the equity capture product as a valuable way for the CDFI to "create a consistent credit culture and serve borrowers who don't fit into even a flexible credit box."

Montana & Idaho CDC: Loan Policy Overhaul

As the Montana & Idaho CDC (MICDC) worked to fulfill its mission to provide financing and consulting services that transform the lives of individuals and strengthen community prosperity, its lending team began to notice that nearly every loan the CDFI made had at least one element "out of policy." **MICDC was making good loans that did not meet its stated credit, equity, or collateral policies. Rather than continue to make routine exceptions to those policies, MICDC decided to make its lending "Better, Faster, Smarter," and to overhaul its policies instead. That meant whittling down the 150-page legacy underwriting policies to just three pages.**

The tables in figure 1 and 2 show the lack of alignment between the stated policies and the lending practice. "We felt like the policies distracted us from better discussion and focus of the true potential risks," said MICDC Director of Lending Betsy Beauvais. The new policies also incorporated a screening instrument called the "Keith Score" to assess potential risk. Named for the professor that helped MICDC create it, the Keith Score is the result of a regression analysis that MICDC ran on their historic portfolio to determine which factors most influenced repayment.

Figure 1: MICDC Policy

	MCDC Policy
Collateral Coverage Ratio	1.00 or above
Credit	625+
Equity	10% or more
Business DCR	greater than 1.0
Global DCR	greater than 1.0
Personal DTI	less than 60%
Use of Funds	No gambling, on-site alcohol consumption or adult entertainment

Figure 2: But in reality…

	MCDC Policy	Actual #'s	in policy	out of policy
Collateral Coverage Ratio	1.00 or above	0.25		√
Credit	625+	615		√
Equity	10% or more	0%		√
Business DCR	greater than 1.0	1.05		
Global DCR	greater than 1.0	1.05	√	
Personal DTI	less than 60%	47%	√	
Use of Funds	No gambling, on-site alcohol consumption or adult entertainment	Permitted	√	

In addition to using the Keith Score, MICDC implemented new lending policies. The previous policies did not directly or accurately reflect actual underwriting practices, so they developed new policies that mirrored how they assessed risk.

The new policies, finalized in May 2016, rely partly on traditional measures of creditworthiness, but take into consideration additional qualitative measures that MICDC believe to be equally relevant to loan repayment. The only policy that remained the same was a continued requirement for a 1.0 debt service coverage ratio. The policies apply to both existing and startup businesses (MICDC's portfolio is about 50% startups).

MICDC's new policies reflect four key areas evaluated with any potential loan client. The four key areas are:

- ***Willingness to repay debt:*** MICDC looks at credit score, credit history, money management skills, bank statement analysis, and personal references. In addition, MICDC has a set of questions that they ask every borrower to assess what would happen if the business failed and how they would repay debt. There is no FICO minimum. This policy replaced the previous FICO requirement of 625.
- ***Skin in the game:*** MICDC assesses equity using a holistic skin in the game assessment. This may include traditional owner's cash or equity injection, however, 90% of their borrowers do not have that level of cash equity contribution. Instead, MICDC accounts for equity with more subjective criteria, such as: how long the owner has been in their business; their personal commitment; the value to the borrower of the collateral they put at risk; questions about what happens if the business fails, and what would prevent the borrower from walking away when things are hard.
- ***Secondary sources of repayment:*** MICDC's analysis found that collateral had almost no impact on the likelihood of loan repayment. While the new policies do place some value on traditional collateral, they also look at other sources for loan repayment: the borrower's personal monthly cash surplus, other options for the business owner to earn money, and additional guarantors.
- ***The business's ability to repay the loan:*** MICDC considers the cash flow of the business and an analysis of its debt service coverage, and conducts regular financial analysis of the business projections.

While the more subjective criteria might seem to slow down the loan process, MICDC is finding the opposite. Rather than collecting numerous papers to document small pieces of collateral, for example, the loan officers' and borrowers' time focuses on having one conversation walking through the "hard questions." The more qualitative process has streamlined the closing process, as well, since the new policies require fewer pieces of documentation.

Lessons

MICDC Director of Lending Betsy Beauvais offered lessons and advice to CDFIs that may be considering a similar review of loan policies:

- While the end result reduced hundreds of pages of policies to three, the three pages could not have come without the past history and use of the lengthy policies.
- Nothing changed in our actual underwriting, except that the policies better reflect how we assess risk.
- Good or even great policies are not a substitute for training and capable staff. Hire the smartest people you can find to implement the policies.

Pacific Community Ventures: Loan Scoring Matrix

After their first few years of small business lending experience, Pacific Community Ventures (PCV) found that their loans were not reaching as many borrowers as they had hoped. PCV provides small business lending and microloans from $10,000 to $200,000 to California businesses creating quality jobs in underserved communities. PCV wanted to reach more of prospective borrowers with low credit scores or limited credit history in its target market and to improve loan decision experience for all of their borrowers.

Historically, PCV relied entirely on an external loan committee for loan decisions. While the broad range of expertise helped the CDFI lender manage its underwriting responsibly, this process added weeks to the process of underwriting and approving a loan.

To meet the dual objectives of reaching more borrowers and streamlining their borrowers' experience, PCV developed a loan scoring matrix[2] that allowed the CDFI to shift most lending decisions to the staff level and even to auto-approve loans that met a point threshold. They began using the matrix in spring 2016.

To develop the matrix, Managing Director, Business Advising and Lending Bob Porter and Chief Financial Officer Carolyn Clark reviewed PCV's existing portfolio. While the CDFI's "pre-matrix" underwriting criteria did not clearly define a "good" loan, the PCV staff compiled the categories of information that had been included in credit memos. That basic information became the contents of the matrix.

Porter then assessed the existing portfolio to understand how current PCV loans would have scored against the draft matrix. His analysis found that the average PCV loan scored a little lower on the proposed matrix than staff expected. These findings helped bolster support for the matrix concept—if PCV was already approving loans of about the same risk, using the same criteria without explicitly doing so, it made sense to use the matrix to streamline decision-making. Because the data shown by analysis of the existing portfolio reflected the proposed scoring, it helped PCV arrive at a comfort level using the matrix.

Adoption of the underwriting matrix has shaved weeks off PCV's loan approval timeline. Borrowers can now complete an online application that asks for the information in the grid. After the first few months of using the new process, only 30% of prospective loans go to the external loan review committee compared to the 100% that previously went to loan committee. Increasing experience and comfort with the matrix has allowed PCV to auto-approve a wider range of scores, including lower scores. Overall, these changes have significantly improved the borrower experience by reducing the amount of information in the application and significantly shortening decision-making.

The new underwriting process has improved the lending experience for staff too. Underwriting staff are empowered with the clear decision-making criteria provided by the matrix. Streamlining of staff work has built internal confidence and improved job satisfaction.

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[2] See Exhibit A.

A key lesson for other CDFIs learning from PCV's experience is that the CDFI did not develop the matrix in a vacuum. PCV was already engaged in a review of their processes and systems, which included reconsideration of underwriting along with mapping their lending and portfolio practices. Implementing the matrix alongside these other processes helped to ensure it was supporting other proposed shifts in business practices and the overall strategy of PCV's work. This thoughtful integration continues to pay off as PCV is considering new software: having information laid out in a matrix provides PCV with the key factors they need to ensure are part of that new platform.

Bob Porter also recommends soliciting input from a wide variety of stakeholders. He received feedback from banks and members of the external loan review committee, but also knew when it was important to stand his ground.

Exhibit A: Pacific Community Ventures' Lending Underwriting Matrix

Lending Underwriting Matrix

Company Name: | Date:

Principal/Guarantor Name:

Amount Requested:

Credit Criteria	Point System: 1 point	2 points	3 points		Points Awarded
Principal/Guarantor Credit Score	550-639	640-699	700-850		
Principal/Guarantor Outside Net Worth	$0 - $50K	$50K - $100K	Over $100K		
Principal/Guarantor Gross Debt to Inc Ratio	40% - 45%	30% - 39%	Under 30%		
Time in Business	<3	3-5 years	>5		
Profitability (Consecutive Years)	1	2	>3		
Debt Service Coverage *	1.00 - 1.10	1.10-1.20	1.20+		
Debt to Net Worth	>1.00	.50 - 1.00	<.50		
Net Worth	$<25K	$25K - $50K	Over $50K		
Current Ratio	1.00-1.10	1.11-1.50	1.51+		
				Total	0

Loans >$150 will be reviewed by the Loan Committee			
Score	X Points	Y Points	Z+ Points
Risk Rating	Acceptable Risk	Moderate Risk	Low Risk
Regular Pricing	9-10%	8-10%	7-9%

Current Loan ($50-150K) Scoring Guide			
Score	X Points	Y Points	Z+ Points
Risk Rating	Acceptable Risk	Moderate Risk	Low Risk
Regular Pricing	9-10%	8-10%	7-9%
Approval	Loan Committee	Internal Committee	Auto-Approved

New Smaller Loan (<$50K) Scoring Guide			
Score	XX Points	YY Points	Z+ Points
Risk Rating	Acceptable Risk	Moderate Risk	Low Risk
Micro Pricing	13%	12-13%	10-12%
Approval	Loan Committee	Internal Committee	Auto-Approved

* proposed debt included

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