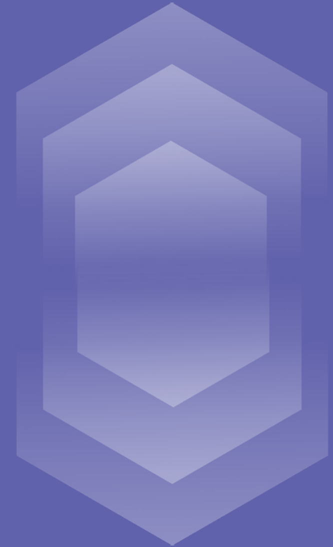
# Alternatively Underwritten Loans



## TL;DR

A fixed interest, term loan offered to small business borrowers but underwritten by lenders based on novel and often nuanced criteria that exclude typical measures of creditworthiness such as FICO or asset collateralization.

# What is alternative underwriting?

The “status quo” capital product in small business finance is the term loan. Entrepreneurs are generally familiar with the basic features of a term loan—probably the most common and widely understood form of capital—thanks to the ubiquity of auto and home loans in the United States. The essential elements of the business term loan are straightforward: a single distribution of capital upon loan closing is followed by immediate recurring repayments of principal loan amount plus interest, based on a fixed interest rate and a pre-established amortization table. There aren’t many surprises to be found in the fundamental economics of small business term loans today, especially from the perspective of the borrower.

There are, however, some significant innovations taking root across the country related to which businesses receive term loans and how lenders assess an entrepreneur’s creditworthiness. Chief among these innovations is a growing trend away from traditional underwriting methods—which tend to rely on historically discriminatory features such as asset-collateralization and individual borrower credit metrics (eg. FICO score)—and toward alternative underwriting measures. While the fundamental capital product remains the same as a typical term loan, an Alternatively Underwritten Loan (sometimes called “Character-Based Loan”) features a distinct and more in-depth underwriting process. This process often foregoes the elements of collateral and credit score entirely, in exchange for an intense focus on individual borrowers’ competencies, business plans, cash flow, and potential trajectory.

Unlike many modern trends in small business finance, innovations in the Alternative Underwriting space aren’t coming from the likes of Silicon Valley FinTech firms, but rather from local and regional CDFIs, nonprofits, and grassroots entrepreneur support organizations in pockets across the country.

## Two Types of Alternatively Underwritten Loans: Standalone & Programmatic

When a lending institution decides to offer debt capital to small business borrowers using an alternative assessment of creditworthiness, they have essentially two options:

1. **Standalone Loan Product:** The lender establishes a systematic application process, underwriting policies, and fund structure to offer a streamlined alternatively underwritten loan product. Business owners apply for capital from the lender just as they would from a bank, and are directed by the lender to submit information in accordance with the underwriting policies. The lender makes loan offer decisions internally based on the underwriting criteria they have decided upon, and the entrepreneur repays the loan exactly the same as any term loan.

2. **Programmatic Alternatively Underwritten Lending:** An organization with the capacity and structure to provide longer-term direct technical assistance to small businesses may decide to incorporate alternatively underwritten debt capital into their offerings for the entrepreneurs they serve. Over the course of a support program or small business development curriculum, debt capital is offered to entrepreneurs based on predetermined program milestones or measures of business success. Entrepreneur creditworthiness is assessed interpersonally, over the course of the program, and is often informal in nature.

# Why Alternative Underwriting?

### Benefits for entrepreneurs:

- These loans are sometimes the only formal capital a business owner can access. Nonprofit lenders who offer alternatively underwritten loans are referred to as the "lenders of last resort," and outside of this option an entrepreneur may be forced to consider astronomically expensive credit card debt or other predatory sources of capital.
- In many cases, these loans and the programs within which they exist are designed to provide technical assistance and support in addition to the lending capital.
- Upon successful repayment, such lenders often have processes to "graduate" borrowers to a more traditionally underwritten loan, or to make warm introductions on behalf of the borrower to larger, more traditional lending institutions for additional capital needs.

### Benefits for lenders:

- Incorporating alternative underwriting practices allows lenders to serve another segment of the market that traditionally processed loans might overlook or disqualify —allowing the organization to increase the total addressable market.
- Alternative underwriting practices allow funders to reach some of the most credit-challenged businesses, which is often core to the mission of nonprofit lending institutions.
- Addressing nontraditionally-creditworthy borrowers improves CDFIs' abilities to reach target demographics and geographies, increasing likelihood of re-certification and grant awards.

## Costs for entrepreneurs:

- Alternatively underwritten loans frequently have a complicated and lengthy application process. Often very little decision-making is automated or based on algorithmic decisions; most commonly, lending decisions are made by a team of lenders and underwriters based on a set of nuanced facts and calculations.

- Typically charge higher interest rates than traditional bank loans.

- May include additional obligations such as ongoing reporting and communication with lending institution, recurring check-ins, and participation in technical assistance programming.

## Costs for lenders:

- Alternatively underwritten loans often lack collateral and personal guarantees, which can significantly diminish the enforceability of default obligations and recuperation of principal.

- Lending teams must be re-trained, and staff obligations are significantly higher for this more nuanced and subjective lending process. The underwriting process is not typically as formulaic as with traditional debt capital, and as such, automation or technological support systems may be more difficult to engineer.

The single most obvious benefit of Alternative Underwriting in small business lending is that it enables lenders to offer capital to viable and important small business borrowers who otherwise would not qualify for a term loan under traditional underwriting guidelines.

Unlike in the mortgage industry, there is no national public database of small business lending by race and ethnicity, gender, or other key demographic variables. However, based on consumer surveys and private research endeavors, we know that female business owners account for less than 5% of all capital loaned to small companies. This comes despite the fact that women own 30% of small companies—six times as much as the share of funding they receive. Furthermore, small businesses owned by women only receive 16% of all traditional small business loans. Women's applications for business loans are also more likely to be rejected, or have more stringent terms, than those for men. Black business owners struggle with debt financing too: in 2018, only 31% of them received all the funding they applied for, compared with 49% of white-owned businesses, 39% of Asian-owned firms and 35% of

Latino/a-owned businesses, according to a 2019 report from the Federal Reserve Bank of Atlanta. Beyond application success, Black business owners also pay higher average fees and interest, due in part to the lack of personal assets to collateralize loans, attributable to the significant racial wealth gap.

# Capital Product Fit

## When is an alternatively underwritten loan a *good* fit for businesses?

**Entrepreneurs who tend to benefit most from alternatively underwritten loans typically:**

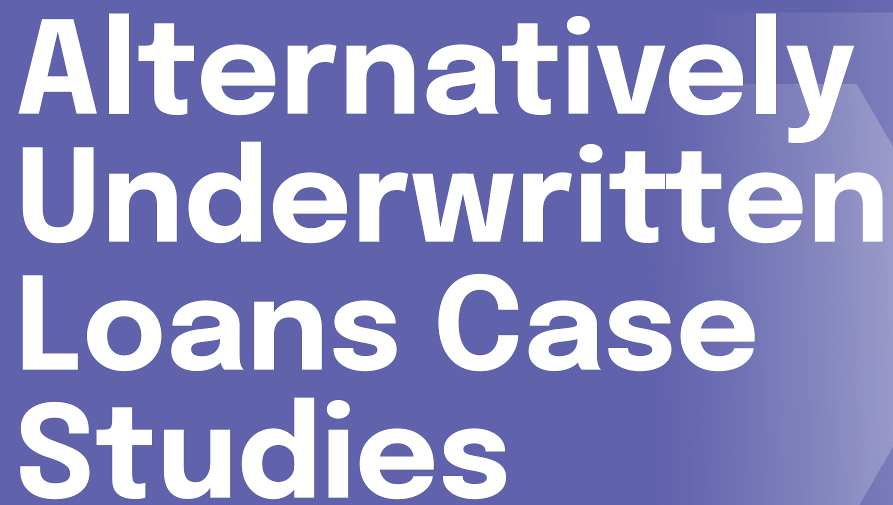
- Have a nonspeculative business with a clear pathway to growth and stability. Most often these businesses are generating revenues and are near break-even on their balance sheet.
- Lack significant formal assets necessary to collateralize a traditional term loan (business assets, home equity, personal assets such as vehicles, etc).
- Have a lower than average personal credit score, sometimes with historical blemishes including bankruptcies, collections, or late payments.
- Have young businesses without the 2+ years of track record many lenders require.
- Lack formal bookkeeping systems to efficiently track business transactions and verify financials.
- Are interested in working closely with a lender to build credit, improve business financials, and graduate to a traditional debt product upon repayment.

## When is an alternatively underwritten loan ***not*** a fit for businesses?

- If a business is speculative in nature, including pre-revenue startup firms. These are typically not a fit because repayment of loan principal plus interest typically begins immediately.
- If a business does not want to participate in hands-on programming with the lending institution, or does not want to provide intimate and personal information as a part of the loan application process.
- If the entrepreneur(s) have strong personal credit and assets, which would likely mean they could access lower cost capital elsewhere.
- If the business' revenues are highly seasonal, with significant peaks and troughs throughout the year. Fixed monthly payments can squeeze already slim cash flows during down times if an entrepreneur cannot afford to budget for future debt obligations.

Small business balance sheets across the country have seen historically challenging circumstances made only more grave by the economic effects of COVID-19. In the wake of an economic crisis that hit small businesses especially hard, entrepreneurs have found themselves spending down assets, liquidating reserves, and defaulting on personal debt obligations—all of which pose significant challenges within the context of a traditional underwriting process for a small business term loan. However, these challenges—whether incurred due to COVID or otherwise—do not necessarily reflect poorly on a business entity's ability to repay a loan. Adopting alternative underwriting practices allows lenders to look past these challenges to still identify and provide mutually beneficial capital products for small businesses.

# Alternatively Underwritten Loans Case Studies



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*Brittany Phelps and a client at Thrive Yoga in Crested Butte, Colorado*

# Overview

B:Side Capital, (formerly Colorado Lending Source) is a highly regarded nonprofit Certified Development Company (CDC) lender based in Denver, Colorado. Over its 30+ year history, B:Side has funded thousands of loans to entrepreneurs in Colorado, most of which have been under the SBA through the 7(a), 504, and Community Advantage programs.

Since 2011, B:Side has offered a standalone direct lending product that has become a staple institution for local economic development, known especially for its alternative underwriting process. These loans, which B:Side refers to as "responsible lending" or "pre-bankable lending," provide capital to entrepreneurs who have viable businesses but may not yet qualify for typical, low-rate bank loans. Over the direct loan product's 10-year history, B:Side has reached hundreds of Colorado entrepreneurs with nearly $9.4M in capital deployed. In 2019, it created a sister nonprofit entity, now called B:Side Fund, to house its direct lending programs moving forward, with a plan to become a Community Development Financial Institution (CDFI) in the near term. B:Side offers funding options according to the following terms:

- Loan amounts ranging from $20K to $100K
- Guaranteed interest rate maximum of 12%
- Typical term length of 7 years
- Funding may be used for: working capital, asset purchases, inventory, business acquisitions, and debt refinance

Ultimately, the B:Side Fund is a highly self-sufficient engine for economic development, yet it still relies on philanthropic and grant capital to subsidize its cost of doing business. This is common for CDC and CDFI loan funds and is typically one of the principal uses of grants from the CDFI Fund.

## B:Side Direct Lending Underwriting Process

B:Side Fund's direct loans differ from traditionally underwritten term loans primarily in the underwriting process. Lenders on B:Side Fund's Direct Lending team think more like venture capital investors; they give credence to entrepreneurs' business plans and potential for future growth. They assess the project in its entirety and are not deterred by borrowers who have taken a nontraditional path and need the extra space to tell their whole story. The B:Side lending team weighs the following key elements heavily in its Alternatively Underwritten loan decisions:

- Business plan and financial growth projections
- Entrepreneurs' industry experience and historical business background
- Business and borrower character assessments

## Example B:Side Loan: Thrive Yoga, Brittany Phelps

In 2017, the opportunity to purchase a yoga studio in Crested Butte presented itself to local resident Brittany Phelps, who, at the time, was working several jobs in the outdoors and fitness community. She immediately started working on financial planning and jumped on the opportunity. Eight months later, Brittany became the proud owner of Thrive Yoga. She opened a second studio location in town and went on to open a third location in Fruita. However, at this stage in her growth, Brittany found her business cash flows squeezed by an unfavorable licensing agreement with the former owners of the business. Ultimately, the former owners of the business wanted Brittany to buy them out, and she needed to refinance their aggressive sellers' note to be able to continue operating the business.

Despite owning and running a successful and growing business, Brittany was unable to secure a traditional bank loan due to her less than perfect credit history. However, when B:Side took a look at Brittany's financials and her business plan, they could see that refinancing her outstanding debt could cut her monthly debt expense in half, freeing up a substantial portion of monthly cash flows for essential business expenses. Ultimately, B:Side lent Brittany $95K over eight years at an interest rate of 7.5% to pay off her debts, which resulted in a monthly savings of roughly $1,500 for the business. With these funds, Brittany was able to continue her plans of growing the business, and B:Side accomplished its goal of bringing lending capital to a borrower who represented multiple target demographics (rural-based, woman-owned).

## B:Side Direct Lending Fund Outcomes

20% of loans made to pre-revenue enterprises

39% of loans made to early stage enterprises—defined as less than 24 months in business

48% of loans made to women-owned businesses

42% of loans made to rural-based businesses

58% of loans were made to businesses located in low-to-moderate income census tracts or CDFI investment areas

After 10 years of history, the loan write-off rate is 5.9% (based on $ amount of initial charge-off, not including recovery efforts)

# Overview

Rocky Mountain MicroFinance Institute is a Colorado-based CDFI, founded in 2008 with the mission to enable people of all backgrounds to realize their unique potential through the power of entrepreneurship. RMMFI focuses on very small businesses in the early/idea stage in and around Denver—providing a multifaceted suite of support services and products. Over its 14 year history, RMMFI has supported more than 300 small businesses, representing a diverse background:

- 100% low income
- 82% people of color
- 68% women
- 57% previously denied a business loan when seeking traditional capital
- 48% households with children
- 10% formerly incarcerated

**RMMFI's programmatic Alternatively Underwritten Lending program is offered in phases, corresponding to the three distinct stages of business support they provide:**

1. **Idea | Program:** 24 hours of education, coaching, and pitch practice through a five-session Business Idea Lab, focused on the foundations of business ownership. Mentorship to encourage both personal and business development. Connections to partner organizations for help overcoming business barriers. Coaching support for preparing an application for Launch bootcamp.

   **Capital:** $500, 0% interest "seed loans" to test viability of business idea

2. **Launch | Program:** 15 hours per week for 12 weeks of mentorship, instruction, and coaching from volunteers and staff according to a proven and specialized curriculum. Discounted accounting services to establish business financial practices. Additional graduate resources include a peer support group, skill-building workshops, a free coworking space, virtual and live marketplaces, and promotion through RMMFI's business directory. In total, the Launch phase of RMMFI programming lasts 15 months.

   **Capital:** Access to Launch microloans (up to $2,500), available to all program participants. Low to no interest, flexible repayment terms.

3. **Thrive | Program:** Cohort-based educational programs focused on the unique issues businesses face as they move from startup to expansion. Relevant mentorship and technical assistance to help navigate the challenges that come with a growing business. Expert-led workshops to continue developing the entrepreneurial and leadership skills necessary for business success.

   **Capital:** Microloans ranging from $5K to $75K, to support the continued growth of the business.

## RMMFI Loan Fund Outcomes

- $878K lent
- 94% loan repayment rate
- 84% business survivorship four years after participation
- 72% of entrepreneurs report increasing their household income