PODCAST TRANSCRIPTION SESSION 46: JACOB HAAR

Welcome to the Lend Academy Podcast Episode No. 46. This is your host, Peter Renton, Founder of Lend Academy.

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Peter Renton: Today on the show, we're going to be talking about something a little bit different. Today's guest is Jacob Haar, he is the Managing Partner and Co-Founder of Community Investment Management. Now they are an impact investing firm focused on the marketplace lending space. We've never really talked about impact investing on the show, or really much at all on Lend Academy and it's something that I believe in personally and I think it could become a much more important part of this industry, so Jacob shares his views on impact investing and how his company is investing in the space with that as their primary focus. It's a fascinating interview and I hope you enjoy it.

Welcome to the podcast, Jacob.

Jacob Haar: Great, thank you, Peter, excited to be here.

Peter: So why don't we get started with giving people a bit of background about yourself. I know you've got not as a typical background with people I have on the podcast. So just tell people about your journey and how you came really to this industry.

Jacob: Sure, absolutely. I think...you know, I have a background in emerging markets investment and in particular the focus on financial inclusion which is essentially serving borrowers who lack access to affordable financial services because they're underserved by banks and typically are using informal financial services.

So I've spent a number of years in Asia, the Middle East and the Caucasus working on the ground. I worked for a micro finance institution that Save the Children ran where we actually made loans to entrepreneurs who in many cases were refugees and the loan started at $60. We were able to build a very successful business with low default rate with that population.

In the years that followed, my partner at CIM, Michael Hokenson, and I started about ten years ago a micro finance and small business investment fund that focused on emerging markets called Minlam Asset Management and invested in about 35 different countries and over 50 specialty financial institutions that all served small businesses through some type of innovative approach. So it's been really…the growth of CIM and the work that we do in the United States was an outgrowth of that path of seeing financial inclusion work abroad.

Peter: Okay, then so where did you...looking at this country, there's obviously plenty of people that aren't included in financial services in general so you decided to start something focused on small business. Why do small business, why do it in this particular industry?

Jacob: Sure, I think...for years when we were investing in emerging markets that ranged from places like Mongolia, Sri Lanka, Tanzania, Colombia working with financial institutions that...ultimately, we're trying to innovate, to figure out how do we better serve a borrower that lacks access because they're thinking about it from the perspective of, as a lender what I need as opposed to what does my borrower population have. That involves really slight innovations such as group lending or taking a woman from a local community, putting her on a motorbike and sending her out to an open air market so she can interact with folks.

There are very similar needs here in the United States, but for different reasons, not because formal financial services haven't extended to small businesses in the United States, but because the decline of community banks and the inability of small businesses to receive bank financing for both structural and also technical reasons, there is a significant opportunity between the short term predatory money lenders and the banks where we have quite a bit of opportunity for small businesses to borrow at rates where they can productively produce.

I think that our impact investment perspective is one where we see that there are opportunities to take innovation and be able to provide productive borrower-focused capital. In the United States there's quite a bit of opportunity, we think, through the technology-enabled lenders that are essentially taking a more transparent, efficient models to the problem that banks and short term predatory lenders we don't think are solving.

Peter: So is that what attracted you to the space? Obviously, you've been in micro finance, you've probably been exposed to peer to peer type products for a while, but was it the transparency, the technology piece that drew you into marketplace lending?

Jacob: Yeah, I think we see a lot of innovation occurring in this sector. It's really a laboratory of innovation in marketplace lending and I think there is...especially now with what's happening in fintech, quite a bit of resources, great minds looking at the problem. And, certainly, consumer peer-to-peer was something that I had personally invested in five years ago and had been following, but because we've spent so much time over the last ten years thinking and investing in financial institutions that look at how to fund small businesses so that they can productively use that capital to create jobs and grow, that has been a real focus of ours and thinking about how marketplace lending and technology-enabled lending can improve that process for all the different parties who are involved, both borrowers and investors.

Peter: Okay, so your company, CIM…you go to your home page and it says CIM is an impact investment firm focused on marketplace lending. So what do you mean exactly when you say impact?

Jacob: Sure, impact investing is a relatively young term. It's been around for about six years, but it refers to something that folks have been doing for a long time...which essentially is intentional investing which is designed to generate social and/or environmental impact alongside of financial return.

What I refer to about nine years ago was the formation of the Global Impact Investing Network which was an initiative of the Rockefeller Foundation that brought together a number of different stakeholders who are actually doing this type of investment and put a community and a vocabulary and a set of research around that. These are generally investments that focus on sustainable agriculture, affordable housing, affordable and accessible healthcare, clean technology, and, of course, financial services, which is where our focus has been.

It involves intentionality, it involves investing with a return expectation so it's not charity. That said, those returns can range from very subsidized to fully market-based which is where we fall...on the fully market-based end of things. It also involves a commitment to measure and report on the social and/or environmental progress and performance of those underlying investments to understand how you are achieving those outcomes driven through data.

Peter: Okay, so I could hear people thinking, how is this going to work in marketplace lending for small business? I know that you've said publicly that you are investing in Lending Club loans, I think you also said Funding Circle. Let's just take those two, for example, and they obviously provide small business lending to a range of industries, a range of different companies, some which will be decidedly non-impact and some that would fit into your criteria. So how do you take your ideals...like how do you approach these online platforms and sort of overlay your impact filter, shall we say? How do you do that?

Jacob: Sure, absolutely. We look at impact in a number of different ways within the portfolio. I would say the first tenet of what we do is really partnering with responsible and transparent lenders. You mentioned Lending Club and Funding Circle, two of our partners that fit right within that and all of our partners really fit within that. That's our investment universe so the way that we look at that is essentially...there are quite a number of different actors in the marketplace lending sector and some that we think have a longer term approach and some that we think have a shorter term approach.

So just like a oil and gas fund, who are focused on oil and gas companies. We focus on those transparent and responsible lenders who ultimately are building their businesses and offering investors the ability to benefit because of the borrowers' underlying benefit and success over a long time period. And so that's the first layer into our investment process.

There's a screening to say who we'll partner with, who we'll invest with and who doesn't necessarily meet that criteria. Then once we go through that screen, there is a fully commercial market-based selection structuring risk assessment process where we look at our partners and their portfolios to try to create the best risk-adjusted outcome for our clients. We're not screening out certain types of loans based on the fact that they're not meeting our criteria other than a set of IFC/World Bank exclusion list where we exclude certain types of businesses such as guns or tobacco, etc. That's a relatively narrow list, I mean, the focus is on supporting small businesses with responsible and transparent products because they play such an important role in our economy.

I mean, since 1995, they've created 2/3 of all new jobs in the United States, they employ half the private sector work force and they account for 50% of non-farm growth GDP. They're an important and underserved part of our economy. We see a lot of impact around supporting small businesses in America and particularly supporting them with responsible and transparent products so that they can be empowered to make good financial decisions and ultimately grow and hire and create a quite a bit of value within communities and society as a whole.

Peter: Okay, so it sounds like your first criteria is the platform has to be transparent, have good practices…so could you be a bit more specific there, like what would exclude a platform from consideration and are there some that are like on the cusp that may need to change one or two things. I mean, can you just go into a little bit more detail about how…particularly how you rule out platforms that you will not invest with.

Jacob: Sure, ultimately it comes down to this assessment as to is this a value extraction or a value creation proposition, the underlying business model. Suppose I was looking at interest rate and how high the interest rate is...I mean, we see in the alternative lending universe interest rates greater than 150% APRs in certain cases. We don't necessarily see that as a sustainable way for small business to fund itself and be able to have a positive return once they've paid the cost of that capital after making their investment. It also approaches to really transparency and I think specifically the two platforms you've mentioned, Funding Circle and Lending Club, I mean, that is a core tenet of their business.

I think that if you were to boil down Funding Circle and Lending Club to one word, transparency is probably the best word that would fit there, part of that is because they've done that through a marketplace approach, but that's essential for borrowers to be able to understand the cost. So obfuscation of terms and hidden fees, those are things that we don't look at as fitting within the partners that we work with and that's really been summarized by an initiative that we've been involved with called the Small Borrowers Bill of Rights that came out recently that we were the first investor to endorse and have taken a leadership position in.

You know, you're looking at six basic principles:

--the right to transparent pricing and terms
--the right to non-abusive products
--the right to responsible underwriting
--the right to fair treatment from brokers
--the right to inclusive credit access
--and, the right to fair collection practices

I would say that all of the partners that we work with have signed on to that and that's the best indication of the types of practices that we think are important to be part of the impact investing mandate that we have with our fund.

Peter: So that makes sense to me but…obviously there's a gray area there. We talked to some of the companies out there that charge higher interest rates, they would argue that interest rate by itself...it can still be a win-win. 150% APR may be a bit extreme, but say someone's paying a 50% APR and that could end up at...there's no reason to say that that is definitely going to be a lose...it's not a good decision for the business owner. I don't think you can say that because there's plenty of business owners that would be willing to pay a 50% APR to win a $100,000 contract...they need a $20,000 loan to really get that $100,000 contract and if they pay like $5,000 over six months that's a really good decision for them. So is it beyond interest rate and it's more about just transparency of being clear about how the terms are laid out to the borrower or is interest rate really...you feel like there is a cut-off and we can't go above a certain APR?

Jacob: Sure, both, short answer to your question. I mean, but your point...yes, there is a certain level of transparency that is required because if a borrower has no other opportunities for financing and they have a project that they need funding for and they understand the terms related to that 50% APR...I mean, in global micro finance we see rates range from 15% at the low end to up to 100% rates all over the world. I don't think it's a pure interest rate question to your point. It is ultimately the ability and the empowerment of the borrower to understand the cost.

Peter: Right.

Jacob: Most of the time, from what I've seen, when a borrower is paying 50%, they don't actually know that they're paying 50%. They think that they're paying less because of hidden fees, because it's quoted as a payback rate, it’s not quoted...where ultimately...the percentage that has to be returned on capital is intuitive, it's understood, but time value of money, is not particularly well understood, especially when it comes to products where there might be variability of the payment schedule. So it's actually difficult to determine how quickly you will be paying that money, but if you look at it on a portfolio basis of those lenders, you do see very high APRs that might not be indicative of the underlying risk.

Peter: Right.

Jacob: So I think what it is ultimately about is empowering through transparency borrowers to make decisions so they can compare apples to apples. I have three loan options in front of me, what is challenging, I think, is what we've seen quite a bit of are borrowers who might choose a more expensive loan thinking it is less expensive and that, ultimately, is what we need to do by creating a transparent marketplace so that borrowers can make the decision as to what is the best product for me with my needs. There are cases, of course, where expediency of getting the financing may be worth additional cost, but the borrower has to have the right information in front of them to make that decision.

Peter: Right, that all makes sense, that all makes sense. Okay, so moving along, can you tell us like when your fund launched and the size of your fund today?

Jacob: Sure, so we started Community Investment Management as an outgrowth of the emerging market work we were doing as I mentioned previously. We started in 2012, but I started focusing full-time on it about two years ago, in the fall of 2013 and we started investing shortly thereafter, so almost two years ago.

We've been very fortunate to have a great community of investors, many of whom we've been working with for ten years through various different projects and products that are focused on both impact outcomes and the long term business model that we have, but also on achieving great risk adjustment returns. Ultimately, because of SEC rules, I can't discuss specifics around the investment products, but we have made a very public commitment out there that with our investors we're committing to fund $300 million into marketplace lending through small business loans over the next couple of years.

Peter: Right, I want to talk about that actually. You came out here to Denver actually for the Clinton Global Initiative and that announcement was made in conjunction with that event. So can you tell us a little bit about why you did it there and just what you're actually committing to.

Jacob: Sure, so our investors and our firm have made this commitment that we will be funding $300 million in responsible and transparent loans to small businesses in the United States over the next two years. We've done that with the Clinton Global Initiative, which is a terrific venue to look at how we solve some of the world's greatest problems and with Clinton Global Initiative, America's greatest problems through corporate action and commitment.

Peter: Right.

Jacob: And we made that announcement with Lending Club actually who announced also alongside us that out of that $300 million commitment we were going to fund $75 million in the years to come through working with them on their responsible and transparent small business loan portfolio. When we look at who we're going to be funding, we've estimated that that will go to just under 10,000 borrowers, about 9500 borrowers and we expect more than half of those borrowers to be minority owned businesses, women owned businesses and military veterans owned businesses that actually today make up 54% of our portfolio.

Peter: Okay, so then you've talked about Lending Club a bit, we talked about Funding Circle, are there other platforms...what other platforms are you investing in? What can you tell us publicly where you're deploying this capital?

Jacob: Sure, so today we invest with four platforms, soon to be five and in addition to Lending Club and Funding Circle, we work closely with StreetShares, which has a focus on military veterans and which is an underserved segment of the small business population, they're 9% of the small business owners in the United States and they're a great organization. Mark Rockefeller and Mickey Konson over there have been building a very borrower-focused, highly impactful, mission-based lender and I encourage listeners to look at them.

Peter: Yeah, I'm a big fan of Mark and his team there, I'm also an investor. They have fractional loans, a fractional marketplace and I've been invested there I think for about a year now, something like that. I think they are doing great work.

Jacob: Yeah, absolutely, and then the fourth platform that we work with is DealStruck and, again, Ethan and Zalman and the team there are just fantastic and they have a real education-based approach so that borrowers that may be paying more for capital without knowing it can get great products that ultimately work within the assets that they have. We have four terrific partners, all that cover the market all in a little bit of a different segment with different approaches and those platforms we think are the best out there and we're adding some other players to that over the years to come.

Peter: So what's your goal, hoping to get to like ten platforms or you're just going to keep expanding as the platforms kind of grow and develop?

Jacob: Yeah, it's been incredible to see the growth in the industry and we've tracked over a 140 different small business lending platforms and it feels like there's a new one every week. I think the great thing is that there is a laboratory of innovation, you know, but there's a lot of risk out there. It's difficult to identify the leading platforms that have a unique approach and advantage in their business model that we think also is important for providing services to small businesses, but also has the management team and expertise that's gone through multiple credit cycles to execute on that. So we certainly are deepening relationships with the current platforms and some that we're adding. I think part of the $300 million that we're allocating over the next two years, we foresee probably seven platforms being a part of that at the max or maybe five to six would be probably more the baseline assumption.

Peter: Right, okay, so you talk about your investors earlier and I just want to focus on this for a little bit where...your investors, you say, most of them are...they want the social impact of their investment, but they also want a good return. I'm just curious, when you're talking with your investors...there's been a lot written of the risks of investing in this industry and particularly given the fact that none of these platforms themselves like some of the people that work at them, but none the platforms themselves have been through a full credit cycle, so what do you tell your investors so that they can get comfortable with the fact that this doesn't have a long track record?

Jacob: Sure, I think in terms of understanding both the social impacts and the financial return aspect, it's interesting, actually, the Cambridge Associates and the Global Impact Investing Network did a study recently showing that the impact funds have, from 1998 to 2004, actually outperformed the conventional funds. So I think perhaps it's somewhat of an assumption that the focus on impact can hamper returns when, in fact, and this has been our experience, we see it actually as a value add to increase returns and actually focus on the best long term partnerships because it's a truly win-win proposition.

It's essentially focusing on those platforms that are aligned with the interest of their borrowers so that you're not going down the road of the sub-prime housing crisis where, ultimately, you're making loans to people who can afford it, but you're really working on the right sizing and alignment of that. So with our investors in looking at the young age of the platforms...I mean, I think ultimately we see quite a bit of risk out there.

You know, out of the 140 platforms that I mentioned, we will see a number of problems with the changing credit cycle. There's too many businesses not with enough differentiation and perhaps not with the right teams to manage that so ultimately it's a focus on having the right partnerships with groups that really do think about managing quality. I think the approach where you're thinking short term to have a certain amount of losses, but where you're charging enough that you'll be fine during a crisis where you see arrears rise, you'll see significant arrears in those portfolios whereas the lenders that we work with have a bit of a higher quality portfolios because they're ultimately working with borrowers that they think can benefit from a more affordable and long term capital source.

Peter: Sure, no that makes sense to me. So I just want to get your feedback on something I was just reading over lunch today. There was a really interesting article about a survey of banks and the article, basically, was saying...the survey said that 68% of banks believe partnering with a non-bank lender will be the best way to revive their commercial lending businesses. Obviously, we know that banks have…they have pulled out of small business lending, particularly some of the smaller banks, they're really focused on real estate now and...I guess my question to you is what do you see as the future for banks, particularly when it comes to small business loans.

I mean, banks, they're not very efficient, in general they take a long time to approve a loan, often these businesses can't wait that long and in general they complained about the cost and they can't originate a small loan efficiently. Basically, the sub $250,000 loan market has really been put up for grabs, it seems, by banks. So do you think that the marketplace lenders are going to completely fill that gap? Do you think there's going to be partnerships where banks will basically outsource their small business lending operation for sub $250,000 loans to these platforms? How do you see it playing out?

Jacob: I think that's a great question, yeah, I think there are both structural as well as cyclical reasons as to why banks are not able to meet the needs of small businesses today. Ultimately to your point, online lenders certainly are capturing a greater and greater share of the market, but it's still just the tip of the iceberg. I mean there is a massive underserved market of both businesses that are…and I think online lenders are bringing more new applicants into the market as well so there's quite a bit of value there.

Certainly, as you mentioned, we see bank partnership. Banks themselves will innovate, they will, I think, bring in more technology. We see banks decreasing the branches, creating more of an online presence. I mean, I very much agree with what Larry Summers said at LendIt which was that ultimately, there's a massive opportunity here for online lenders to serve small businesses and that will grow. The question is, I think, what happens with regulation, what happens with some of the structural issues long term that make it so online lenders have the ability to serve borrowers in a much better way today than what banks have.

I think some of those cyclical issues will change so that the home equity and other collateral sources for small business owners will come back over time, lenders' risk aversion will subside slightly. You know, there are different issues that I think will bring banks back into this market in a larger way directly, but, ultimately, these major structural changes that have been there for 30 years where community banks that were the primary source of lending to small businesses have...their numbers have halved since 1985 and as a percentage of the banking assets it's miniscule.

So the fundamental shift is that character-based local lending is just not there today the way it used to be and online lenders are, from what we've seen, the solution to that, provided that they take a long term approach and are tapping additional data and innovative ways so that they can serve that market long term. I think we'll see quite a number of bank partnerships like we already have and I think those will increase over time, but there is significant room for online lenders to create market share and go out and serve small businesses with badly needed services so that we can ultimately have a better functioning economy and we can see more job creation and growth.

Peter: Yeah, that makes sense. Before I let you go, I just have one last question about your company. What does the future hold for CIM? Are you focused in the US, I mean, there's obviously huge opportunities outside the US as well and you have a lot of experience outside the US, tell us about what your long term plans are.

Jacob: Sure, I think there's so much happening so quickly in the marketplace lending sector that, to your point, it's very exciting what the future holds in emerging and in other markets, but the United States has a large and dire need for responsible and transparent small business lending so that's really our focus. I think over time, as we see better sources of data expansion, there will be some very interesting opportunities abroad and, of course, with our background we'll be in touch with them, looking at that, but as far as we see it today, the United States is now a $200, $300 billion opportunity in small business lending and something that is highly impactful...and where we're very much focused at the moment.

Peter: Okay, well on that note I'll let you go. Really appreciate your time today, Jacob.

Jacob: Thank you so much, Peter. It's a pleasure talking with you.

Peter: See you.

Jacob: Bye.

Peter: We've seen impact investing and social impact investing in the stock market for the last couple of decades has become quite popular. Some of the funds are really very large now and I think this sector...I mean, Jacob's obviously a trail blazer and I really like to think and I believe that in this industry it's going to become more important as well. I can foresee a time when you're really going to have...digging into the details of the loans on the consumer side or the small business side focusing on underserved areas potentially, focusing on underserved industries and people that are doing the most impact. What Jacob's doing is a great first step and I think he'll be the first person to say it's sort of not the final end-play, but I think it's great that he's brought this new awareness and approach to the industry and I certainly wish him all the best.

On that note, I will sign off. Thank you very much for listening and if you haven't done so and you like the show or if you don't like the show, please go and give us an honest review on iTunes or Stitcher, really appreciate the feedback and let me know what you think. We'll talk to you next time. Thanks for listening. Bye.

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