PODCAST TRANSCRIPTION SESSION NO. 130-KEN REES

Welcome to the Lend Academy Podcast, Episode No. 130. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt.

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Today's episode is sponsored by LendIt USA 2018, the world's leading event in financial services innovation. It's going to be happening April 9th through 11th, 2018 at Moscone West in San Francisco. We're going to be covering blockchain, digital banking and of course, online lending as well as other areas of fintech. There will be over 5,000 attendees, over 250 sponsors and registration is now open. Just go to lendit.com/usa to register.

Peter Renton: Today on the show, I'm delighted to welcome Ken Rees, he is the CEO of Elevate. Elevate is an online lending platform focused on nonprime consumers. They recently did an IPO and they're doing very, very well. So I wanted to get Ken on the show, talk about his company, talk about the products they offer and how these products actually help their customers, how they help these people become more financially secure.

So we talk about that, we talk a lot about their underwriting, the automation they use, their approach to analytics. We talk about the CFPB ruling that came out recently and how that's going to impact his company. And we also talk about some of the research they're doing with the Center for the New Middle Class. It was a fascinating interview, I hope you enjoy the show!

Welcome to the podcast, Ken.

Ken Rees: Thanks, Peter.

Peter: So I like to get this things started with just giving the listeners a little bit of background about yourself. It looks like you've had quite an interesting career to date so can you just give the listeners…just tell them what you've done so far in your career.

Ken: Sure, after business school I started as a management consultant rising pretty quickly to be the Head of the West Coast Financial Services Practice for CSC and of course, spent a lot of time with large banks.

In particular, one project that was really transformational for me was related to a large bank's branch infrastructure and talking to branch personnel, they kept referring to lobby trash. I was trying to figure out what they were talking about, the lobbies looked pretty clean to me, I didn't see any trash around. (Peter laughs) I finally figured out they were talking about customers, they were talking about the check cashing customers in the branch and they were just desperate to get these customers out because they didn't want to have to do business with them.

It sort of signaled to me that there are really a lot of people who are not well served by banks and maybe there's a way to use technology to serve these customers better. So when I left management consulting, that's what I did. I started up a technology company that put check cashing technology into convenience stores and grocery stores and help customers put the proceeds, their check, cash and transactions on to prepaid debit cards. That business was bought by GE.

And then after that transaction, I was asked by a gentleman I knew who had started up a business if I would take over for him. He was a Fort Worth business person and really saw that his business that he'd started was growing pretty rapidly and would I take over and grow it. This was one of the first online payday loan companies at the time, it was called Payday One. I stepped in as CEO and began to understand the unique needs of non-prime credit customers and we pretty quickly began, you know, moving away from the payday loan product.

At the time, they had some really interesting technology, in fact, they were the first company to fully automate a loan transaction in that space, but as I began to understand the unique needs of our customers, it became clear to me that a payday loan product wasn't really going to do it. So we worked towards longer term products, installment loans and lines of credit and as we grew that business, we began to think that we could be a public company.

So we actually spun off a part of the business, the direct to consumer part of that business into what's now called Elevate. In fact, we launched the products that are part of that spin-off in 2013 and then in 2014, spun it off and then this year we went public. So we are now a public company, about four years after coming up with the idea of what has now become Elevate.

Peter: So then Elevate had it's origin many, many years ago, it sounds like. Was this something brand new that...you mentioned the Fort Worth business person, is this something separate to that? Was it a brand new company or how did it actually germinate?

Ken: It was really an evolution. As I mentioned, when I started down the road of providing...you know, using technology to provide better options for underserved consumers, it was in the world of check cashing and then getting into the world of lending focused on the needs of non-prime consumers was really eye-opening for me. We have developed a very unique perspective on the type of products that are responsible for consumers, we've developed a unique set of analytics and technology to serve an ever difficult to serve and underwrite customer, you know, non-prime consumers. I think we've also built a really great culture of a company that is very mission-focused and doing our best to push ourselves to deliver better, better products and capabilities for underserved consumers.

Peter: Okay, so let's talk about those products. Can you just walk through what you offer today at Elevate?

Ken: Yeah, so we have three products, all online, in the US and in the UK; two in the US.

One is called Rise, it's a state-originated line of credit product so it's available in 17 states today, a few more coming. That product is all about financial progression so it's about taking customers who may have had a payday loan or a title loan, have not gotten access to traditional forms of credit or maybe even pushed out of the banking system for a variety of reasons and helping them progress over time. So rates that go down over time, we report to credit bureaus, we provide free credit monitoring financial literacy tools for customers.

The second product is one that we partner with a third party bank and that's called Elastic. Elastic is really a financial safety net for consumers, it's a line of credit, sort of like a credit card without a card. That's our fastest growing product available in 40 states.

In the UK, we have a product called Sunny, which is also really meant to be a financial safety net for consumers that have limited other options and that has sort of grown to be probably the number one or the number two product in its category in the UK.

Peter: Okay, I want to just dig in a little bit into the products here and let's look at the Rise and the Elastic product. How does it work and how is it serving your customers in a way that will help them improve their finances?

Ken: Right, it's probably worth maybe taking just a step back and talking a little bit about the customer we serve.

Peter: Right, that's a good plan.

Ken: We're serving really the 2/3 of the US that have a credit score of less than 700 or no credit score at all and that's sort of the first eye-opening fact about our space, is just how big it is. It's twice as big as the world of prime lending and of course, deeply underserved, banks don't serve our customers. In fact, just over the past ten years, banks have reduced another $150 billion of credit availability to our customer base.

So those customers have really been pushed into the arms of payday lenders, title lenders, pawn storefront installment lenders and these products are a) expensive b) because of their fairly inflexible repayment structures they can sometimes lead to a cycle of debt and then they also have what I call the "roach motel effect" (Peter laughs) which is that customers who check-in to a world of non-prime lending, find it hard to check out because these products don't report to the big bureaus and they don't really focus on helping that customer have more options over time. So that's really where our products fit into.

We have developed a technology platform that provides for instant decisioning which is critical for our customers because our customers can't wait a few days like a bank customer can for funding. They need their money as soon as possible and they need a decision very fast and a simple decision process. What we've done is...as I said, we risk score the customers coming through the door with our proprietary risk analytics and then price to that risk and then our guarantee is that based on successful payment history, that that rate will go down over time.

And while that is happening, we're reporting to credit bureaus, we're providing free credit monitoring, free financial literacy tools and what we're hoping is that...this is our motto, is we want to be good today and better tomorrow for our customers, we want to have a good product that's a good competitive alternative to the real world products that they are eligible for, but also help them be better with credit over time, help them build up their credit scores, lower the cost of credit. And, hopefully, some of the customers will ultimately graduate away from our products.

Peter: Right, right. So then are these one-month loans, 3-month loans, what are the typical terms on these?

Ken: Yeah, we find that...in fact, you're getting at a great point about so many of these non-prime credit products, you know, the most well known being a payday loan which the idea is that a customer needs $600 or $700 for an emergency expense and they're somehow magically going to have the money to completely repay that in the next pay period. Of course that isn't true and they need to re-borrow and that's what leads to this cycle of debt. So we allow the customers to schedule their own repayment terms, what works for them, up to a maximum of two years, but typically, customers will pay back early, they'll pay us off in about 12 to 14 months is the average repayment term.

Peter: Okay, okay, so then what are the costs to the consumer? You know, what are the interest rates, what are the charges that you're charging?

Ken: Yeah, we're definitely a higher cost lender because we're serving a riskier customer base.

Peter: Sure.

Ken: And in particular, because we're serving a riskier customer base without taking any collateral and without aggressive collections practices so we feel that one of the things that's important in this space is to not be somebody that would pile on if a customer has any sort of ongoing financial stress. In fact, we're largely serving a customer with limited savings and fairly high levels of income volatility so oftentimes, our customer will have some sort of financial issue over the course of their loan so we have no late fees. As I said, we don't take any collateral on the car, the house or anything like that.

Our rates start in typically the low triple digits which is obviously higher than what a prime customer would pay, but compared to the 400,500,600% of a payday loan or a title loan or the effective rate of a pawn loan, it's a pretty good deal. We will then get that customer down to 36% over time with successful payment of the product. So it's really a...you know, the Rise product in particular is really a transitional product to help that customer progress back towards mainstream forms of credit while providing them with a way to get access to the funds they need quickly, but not have the concerns that they may get trapped either by the cycle of debt or by worse, issues around aggressive collections practices. I think the worst situation in our industry is the world of title lending where 20% of title loans end in the customer losing their car. That's obviously a pretty drastic situation for a customer that in many cases is borrowing funds to pay for auto related expenses.

Peter: Yeah, and the CFPB have come out recently with some new guidelines around this or new rules around this. I'd love to get your thoughts on it because the title loans that you just talked about are some of the ones that they're trying to target and obviously payday where these are predatory loans for the most part.

I'm sure there are examples of good actors in this space, but there's a lot of bad. And so I wanted to get your thoughts on the new ruling from the CFPB basically saying you've got to understand the borrower a bit more, you've got to basically take into account their propensity to be able to repay the loan. So what do you think about what they've done?

Ken: I'm pretty certain that we're the only people in the non-prime lending space that are 100% supportive of the new rules. We think the CFPB got it exactly right, they focused on the pain points for customers which is this sort of single payment nature of some of the products that are out there and so they basically said that a single pay or balloon payment payday loan is going to have very significant usage caps on it to avoid the cycle of debt. Now it's basically going to wipe out that entire series of products.

The other thing that they said is they want lenders not to focus on collections, but to focus on underwriting and when I joined this space that's what I heard from everybody...you know, when I would go to the industry conferences they would say, why are you investing in analytics, this is not an analytics business, this is a collections business. We just never thought that and in fact, that's what the CFPB is basically saying, is you know, you have to do true ability to repay calculations, you have to truly underwrite and you can't predicate a credit just on the fact that you may have access to that customer's car or be able to use aggressive…even lawsuits to get your money back. So we think they did that right.

And then the other thing they added on was a limitation on how lenders could re-present payments to that customer's bank account which is also a pretty smart thing that the CFPB did. So we think it was a very good thing for consumers, it’s of course also a very good thing for us because the rules, when they're ultimately implemented in 2019, will reshape the industry entirely.

They will basically cull out most of the payday lending in the US. They should because of the requirement for more sophisticated underwriting really push a lot of the mom and pops, in particular the brick and mortar, mom and pop locations you see in bad parts of town and in strip malls across America. Those people will essentially be pushed out and we'll see more consolidation towards more sophisticated lenders and we’d imagine a more focus on technology-based fintech lenders like Elevate.

Peter: Got it, got it. So let's talk a little bit about the underwriting process then because you already mentioned that you do instant decisioning so obviously it's automated. Can you talk us through like what kind of data you're using? Are these applications coming in on a cellphone, explain the underwriting process and your approach to the data analytics you've been talking about.

Ken: What we do is really hard, there is a reason that we don't face a lot of competition in the online lending to non-prime consumers because it's just a lot harder than lending to prime customers. You know, in the world of fintech as you know, every new startup talks about big data and machine learning and advanced analytics. However, the truth is if you really push hard they will say these capabilities only give sort of minimal lift over old fashioned underwriting processes like FICO scores. In fact, if I wanted to start up as a prime oriented lender, I could do a pretty good job originating credit to customers with 750 FICO scores, I wouldn't need a whole lot of sophisticated analytics.

In our world, though, FICO score is actually inversely correlated with risk meaning if we ever see a customer with a 720 FICO score applying for credit, it's almost guaranteed that's a synthetic identity or some sort of a crook. So in our world we have developed, and this has taken years...we have served now almost 2 million consumers in the US and the UK with almost $5 billion worth of credit. With each loan we get better and better, we continue to invest in our analytics, in fact, we're investing between $50 and $60 million a year in technology and analytics on a go forward basis.

Where we've ended up is instead of sort of a monolithic approach to underwriting like you do with FICO score in many of the prime lenders, we've created what we call "customer archetypes," and so when you think about the different types of customers, we serve a credit invisible who is maybe a millennial, has never used credit before or very limited credit history. We serve credit challenged people and a good example of that is the single mother that went through an expensive divorce and charged off all of her credit cards and now no one will give her credit cards, but she has been using payday loans and actually, she's been a good customer as a payday loan customer.

Or, we just have these sort of over extended prime-ish customers, people that have never used alternate forms of credit, but have really used up all of their traditional forms of credit and now are forced to look elsewhere. As you think about each of these, it's no surprise that they each need different types of data. A millennial is not going to have extensive credit bureau information so it's really important to look at issues around stability of that customer, get bank account information so we can try and get a sense of how that person is using their money, the cash flows of the customer as opposed to maybe a credit challenged customer where some of the sub-prime credit bureaus can be really predictive and then, of course, with prime customers there's a lot of good credit information.

So we put all of that together...in the past, I said 10,000 pieces of data and I was corrected by our head of data science who said, you know, it's way more 10,000 pieces of data going into our scores and we build them very separately with these unique customer archetypes in mind. Of course, the challenge as a lender that's pretty heavily focused on machine learning and even trying to think about how we can start using true AI in our underwriting is the sort of balancing the potential upsides for underwriting which are pretty big for these more non-linear analytical approaches with the requirement to adhere to all the regulatory requirements to actually provide notices of adverse action and fair lending and all of that.

I think we've done a very good job of getting the best from the analytics while continuing to be very laser focused on not getting ahead of ourselves from a regulatory perspective. At the end of the day, the core to our existence is advanced analytics and doing a better and better job of understanding the true risk profiles of our customers and the broad set of these 160 million Americans. So we in fact, have a whole separate team in San Diego that's just focused on advanced analytics, separate from the team that does the day-to-day management of risk to make sure that we keep thinking about how do we push this forward on an ongoing basis.

Peter: So then I'm just thinking about the application process itself. What percentage of these are coming through on a cellphone versus a desktop?

Ken: You know, it's so interesting, when I started people said the non-prime customers, they don't have computers, they won't go online. Well that's of course ludicrous, everyone in the US has moved online and if it's not through a computer, it's through a mobile device, as you've said, so we're probably in the 65% to 70% mobile device.

But what is interesting about the non-prime customer is their need for fast decisions. You know, if I went to a marketplace lender, I may wait a few days to get my money and there may be somebody that I have to talk to and provide some additional documents and that's okay. In the world of prime it's all about just shaving a little bit of money off of your interest rate and so convenience and speed isn't as important.

In our world, our customers need that money right away because they're dealing with an immediate financial issue so 95% of our applications are fully decisioned, yes or no, without any human oversight, without any manual underwriting, without any documents and that's what we're continuing to push forward on to make sure that we can provide the most convenient, easy transaction for our customers.

Peter: And then how quickly do they get the money once you say yes, how quickly do they have their money and what form does it take because a lot of these people don't have bank accounts, right?

Ken: Good point, we do require that all of our customers have a bank account.

Peter: Oh, you do, okay.

Ken: And in the US actually, the number of people that truly are unbanked is still pretty small, it's maybe only 7% of the US so we lose a very small percentage of our customer base because we only work through bank accounts. But we, in the US, we sort of fund the customers' loans by ACH overnight into their checking account and in the UK within minutes via their payment system.

The good news for American consumers is that finally the US is starting to catch up with the rest of the world (Peter laughs) in terms of payments. So we'll have same day ACHs' and very soon, the instant funding opportunities are going to become better and better so we look forward to actually providing the sort of credit availability such that if a customer is worried about, for instance, a payment coming in that may overdraw them that we can instantly put those funds into the bank account and prevent overdrafts. That's a pretty exciting next stage in the development of Elevate and I think the industry as a whole.

Peter: Sure, obviously you've got some borrowers who are going to, either willingly or unwillingly, not pay you back. Can you give us some stats or some information on the delinquency rates for your products?

Ken: Yeah, certainly, when we look at our financial objectives as a public company they're really threefold, strong top line growth and we have delivered that with...as I mentioned, we grew from $72 million in revenue in 2013 to nearly $700 million in revenue in 2017 also expanding margins and then the third being consistent in improving credit quality. So in terms of charge-off rates for us…a few years ago, when we launched the products, we were ranging between 25% and 30% charge-offs and now we're ranging around 20% charge-off rates and that's because we continue to invest in analytics and we have maturing portfolios which helps with that.

But ultimately, our goal is not to drive charge-offs down to zero. The best way to do that is just by serving a very, very limited number of customers. We think our products need to be for everyone. I'll give an example of that, there's been a few startups that have talked about how they want to use machine learning and new analytics to be able to identify those customers that look non-prime, but actually have very good credit profiles.

The example is almost always the guy that just graduated from Harvard (Peter laughs) and doesn't have a whole lot of credit history. Well that's a great product for the Harvard grad, but our focus is the rest of the US so we think our charge off rates, as long as we keep them consistent in the bands where they're at right now, support the kind of growth and profitability numbers that we have delivered to date and I think we can continue to deliver going forward.

Peter: Okay, so I want to ask about the funding of these loans, I mean obviously, I presume most of your revenue is coming from the spread between your cost of capital and the returns you get from your loans. I presume you have some facilities with different lenders, can you tell us a little bit about that side of the equation?

Ken: Yeah, you're exactly right. In fact, a few years back, as the marketplace lending model was really booming, it was suggested that maybe we should shift into that model and we really never were comfortable with it. We were always worried that if something happened to the access to funds all of a sudden your ability to continue to grow your business could really be put into some jeopardy, that's obviously some of the things that have happened in the broader marketplace lending space over the past couple of years.

So we've always felt it was important to control our own destiny so we have lines supporting the products that we directly originate and then for the bank originated products, a third party, unaffiliated special purpose vehicles buy participations in those loans to support their growth. We've now got I guess something north of a half billion dollars in active balances through the combination of those direct lines that we've gotten from third party lenders as well as from the special purpose vehicles that fund the bank products.

Peter: Okay, so I want to talk a little bit about this Center for the New Middle Class that's on your website here. It looks like you do research on different behaviors and attitudes around money, can you just tell us a little bit why you've done that, and what you're hoping to achieve and what it actually does?

Ken: You know, in our space, and I think in the broader world of lending, people still don't get our customer...I think there's a bit of a bubble environment that goes on certainly in places like Silicon Valley where you have to look long and hard to find a non-prime consumer. What we wanted to do is raise visibility for the broader world, for policy purposes as well as just helping people understand the unique needs, but also we wanted to use it to help understand our customers' unique needs better to help drive our product development.

So we established a research arm called the Center for the New Middle Class and they do a variety of research studies typically into understanding sort of the pressures and demands of non-prime customers versus prime customers. In fact, we did a really interesting project with Clinton Global Initiative on testing a variety of different tools to help customers improve their financial health and we learned a lot of really interesting things about what works and doesn't work. But some of the things we find out is these really amazing statistics about the differences.

You have, of course, the non-prime customer, almost half of them have been turned down for credit in the last year whereas a prime customer it's only 5%. For a non-prime customer, they look for speed of access to credit, they look for simple products with no hidden fees and no aggressive collections practices where for a prime customer, it's all about APR. In fact, only less than 20% of non-prime customers put lowest APR even in their top three criteria for a loan.

So it's just a very different world and the Center for the New Middle Class has really done a good job to help push our thinking on how to better serve our customer and has increasingly become a good policy tool for people in DC and in the media to better understand this growing population within the US and it is growing. I mean, the world is very different from the way it was 20 years ago or 30 years ago and the middle class has been hollowed out as no longer that thriving robust middle class with savings and increasing income, but is now a new middle class with very little savings and a lot of income instability.

Peter: Yeah, understood. So we're almost of time, but I want to get your take on the IPO and being a public company now...I mean, you went public earlier this year, you've been up and down within a certain range, I think you're reasonably flat, I believe, from when you IPO'd as far as pricing goes unlike some of the other companies in the online lending space that have had a harder time of it, so I guess a couple of questions here. Firstly, what was the process like going through the IPO and how has it changed your company?

Ken: I'm not sure I'd recommend our IPO process on anyone else, it was very challenging. We came out after...I think there was a lot of upheaval in the world of fintech lending, the marketplace lenders, the small business lenders who are struggling and there was a lot of skepticism about our IPO. We did get it done, but we feel that we are undervalued and in a lot of ways that's actually freed us up. I have to say I'm not sure I would have looked for an IPO where I felt we didn't get the price we wanted, but the great thing about it is it's really allowed us just to focus on building a great company and just continue to do what we're doing.

In fact, it's given the whole company this sort of great culture of, you know, we're going to show them. And that's sort of what has happened, you know, we continue to show really outsized growth, I mean, I'm not sure I'm aware of any other fintech lender that's bigger, more profitable and growing faster than we are. We believe that we can continue to see that sort of growth for the long term, we're already seeing sort of a billion dollars in revenue ahead of us, not too long. We're thinking about how do we become a Fortune 500 company, how do we get to $5 billion in revenue, how do we add new products to serve this deeply underserved segment of Americans and people in the UK; we'll be adding a credit card, for instance, next year.

So we've got a lot of innovations that we still want to do, whether it's innovative new analytics, innovative new products, innovative new services to help customers continue to improve their credit; whether it be sort of robo-coaching for credit counseling, whether it be more things that we can do to help customers have more flexibility and get their products paid off over time even though they may have some financial upheavals in their lives. It's actually a really exciting opportunity for us as we grow and just are able to tell the story of the non-prime customer in a way that hasn't been told in the past.

Peter: Okay, well we're going to have to leave it there. I really appreciate you coming on the show today, Ken.

Ken: Thanks, Peter, it's been a pleasure.

Peter: See you.

Ken: Bye.

Peter: I just want to go back to something Ken said there talking about this non-prime consumer, two thirds of Americans, it's double the prime population. We look at all of the companies in the online lending space and the vast majority of them are serving prime consumers or near prime consumers and the opportunity is much bigger at the lower end of the spectrum. Sure they say they're harder to underwrite, it's not as easy to get data on these people, but with the technology we have today and the analytics tools we have today, I think that this is the big opportunity we have in front of us and I applaud the efforts that companies like Elevate are doing.

There are others as well that are focusing on this space and I would like to see more. I think this is the promise of fintech that we really can expand access to credit, expand access to financial services, something I feel very, very strongly about and I would like to see more being done in this area.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

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