



## **PODCAST TRANSCRIPTION SESSION NO. 190 / KAREN MILLS**

Welcome to the Lend Academy Podcast, Episode No. 190. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of the LendIt Fintech Conference.

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Today's episode is sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's going to be happening April 8th thru 9th, at Moscone West in San Francisco. We're going to be covering digital banking, blockchain, financial health 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](http://lendit.com) to register.

**Peter Renton:** We have a very special guest on the show today. I'm delighted to welcome back Karen Mills, she is the former Head of the Small Business Administration under President Obama. In fact, she was Head of the SBA during one of the most challenging times for small businesses in the last eight years during the Great Recession.

So I wanted to get her back on the show because she has just written a book that is about to be published and we want to talk about that. We cover a lot of topics, we talk about the state of small business lending today, some of the structural challenges within small business lending, we talk about the future of banking when it comes to small businesses and we talk a lot about regulation, the role of companies like Amazon, PayPal and Square and Karen shares why she's very optimistic about the future prognosis for small business lending. It was a fascinating interview. I hope you enjoy the show.

Welcome back to the podcast, Karen!

**Karen Mills:** Delighted to be back.

**Peter:** Okay, so you know, we last had you on the show...it was just under four years ago and you talked about the opportunity and the future of small business lending and I wanted to start off with....maybe we could look back at the past three or four years and certainly a lot has changed, maybe we could start by talking about how has small business lending evolved over the last four years.

**Karen:** Well, fintech and small business lending have really changed tremendously over the past four years. Right at the beginning of that time when you and I were talking, there was this rush of excitement and we called it the "Wild Wild West." Hundreds of companies were opening and then there was this pull back, this moment of pause in the whole innovation curve.

Interestingly, the dynamic is now even more powerful, in terms of how technology is going to change, because since that time, technology companies like Amazon and PayPal and Square have become major factors. Banks have woken up and the Artificial Intelligence and machine learning applications for lending and financial services have blossomed and come to the front



and with them the fintechs, the small innovators have come back into the market. So we are at a really exciting inflection point right now, probably even more exciting than the "Wild West."

**Peter:** Right, and probably it's more rationally exuberant as opposed to irrationally exuberant to sort of how it felt like. Looking back now that time, 2015, it was just a crazy time when money was just being thrown around in amazing fashion, if you remember.

**Karen:** Yes, the good news about that moment is that it was a moment that forced the incumbents, the banks and the old dinosaurs to wake up.

**Peter:** Yeah.

**Karen:** But it was a moment based on really only a surface innovation in some ways. The innovation was important because it dealt with the pain points in small business lending. The fact that it took, you know, three weeks or three months to get a response and you were xeroxing a pile of paperwork to carrying it down to the bank and this idea that you could complete an application in half an hour and get the money in your bank the next day, this was revolutionary.

You really have to credit the entrepreneurs and the innovators at that time for turning the whole thing, opening the spigot, then the issue became....you know, the new entrants really did not have competitive advantage, they had a very hard time accessing customers and they didn't have a low source of capital. Banks did, they had deposits, banks had customers so they needed to come up to speed and respond. That took some time and now we have a lot of major players in the game innovating at an even higher level because of the input of new data techniques and API's and the ability to take algorithms and Artificial Intelligence to the next level.

**Peter:** Sure, so I want to start talking about your book. As we're recording this, it's not yet published, but it will be soon. I mean, it's called "Fintech, Small Business and the American Dream-How Technology is Transforming Lending and Shaping a New Era of Small Business Opportunity." So I guess, first question I have is why did you decide to write this book?

**Karen:** Well, Peter, as you know, I was the Head of the US Small Business Administration and part of President Obama's cabinet. I took on that job and joined President Obama exactly ten years ago at this time and I don't know if everybody remembers how difficult that moment was. Credit markets had frozen, banks had overextended with their mortgages and they literally stopped lending to small businesses. Many, many small businesses had their credit lines pulled and we had a really serious situation in the first quarter that I was in office; we lost 1.8 million small business jobs.

So I was determined that we would try to get small business lending started again and I managed to convince President Obama and Larry Summers who was then the Head of the National Economic Council to let me do something pretty bold, in retrospect. I had come into government from venture capital so I was used to trying to solve the problem and this seemed



to be a particularly difficult moment and we were able to raise the loan guarantee rates on SBA loans to 90%.

When we did that, it was like flipping a switch. We got a thousand banks back to SBA lending in six months; banks that hadn't been making loans for the past several years and we put out \$30 Billion of loans that year, record amount, and for the next several years. So that taught me a really important lesson. That is really when the book began and I talk in the presence of the book about this moment when I was down in Arkadelphia, in the middle of a saw mill and it was freezing cold in the middle of February.

I was with the small business owner and his wife who was the bookkeeper and she turned to me and she said something that really sort of changed my perspective on the day and really I think led to the writing of the book. She said, you know, you saved our business and they had then....just on the brink, unable to get a small business loan and I realized how important access to capital is to so much of our economy.

So when I was here at Harvard Business School writing white papers about the recovery, I began to get involved in fintech and how technology was starting to focus on this market and changing addressing these customer pain points we talked about. I began to realize that technology had the potential to really transform small business lending and really take away some of the frictions that exist in this part of the economy and in that way have an enormous positive impact on these important contributors.

**Peter:** Right, right, I totally get, you know, how important that is. I mean, obviously that's what we.....I've dedicated myself the last ten years to sort of talking about this, exploring this and learning, but I want to dig into some of the contents of your book.

I want to start out with something that I didn't know and surprised a little bit that there has actually been a decline in the number of new businesses that are being started in this country and I think you share some specific data in the book. That was a surprise because I thought that, you know, it's easy when you're involved in sort of fintech and there's so much happening these new businesses starting left, right and center and you think that happens all over the economy. But the reality is there are fewer small businesses being started today than there were ten years ago and certainly the percentage has gone down quite significantly. So why do you think that is?

**Karen:** Well you've identified what I think is one of the most worrisome trends in the US economy which is that the rate of small business starts is way down and it has not recovered after the Great Recession. We used to start 550,000, even up to 600,000 small businesses a year, we're down to 450,000-ish and there are a lot of theories about why this is so, but the economists have really not come together and understood the problem. They've identified it, we've quantified it, but we don't really know why.

One hypothesis, of course, is this access to capital. There are some other hypotheses about permits and regulation and there's a lot of innovation and idea that we had at the SBA, we



called it "Startup in a Box." How can you use technology to just let somebody go online and immediately know all the permits they need to file, all the paperwork they need to fill out, apply for, you know, a credit card and a bank account and a domain name, how could we make it easier for people to start a business. So that's a really interesting area and I know big technology companies and some new small technology companies are addressing that problem. I'm really focused in the book on the access to capital piece.

**Peter:** Right, right.

**Karen:** And it's very hard, of course, for startups on main street to access bank capital because they are new, but if we can figure out how to address some of the issues that I identified in the book, particularly what I call "Information of Past Deeds," (?) it's very hard for a young business to show that they're creditworthy. And it's really actually very hard for any small business to show a bank and be transparent about their prospects and whether they're making money a lot of times because they don't even know themselves. So this one of the places that, of course, technology can help take away some of the barriers and frictions of the market.

**Peter:** Right, right, but at the same time you talk about....there are certain structural challenges that really come with small business lending. I mean, you talk about it in the book. You know, the decline of community banks and community banks have often been the ones that are closest.....obviously, they're closest to their community and they know these small business owners personally.

When they decline, it's harder for small businesses to get access to capital then there's the lack of a secondary market like the securitization market which...obviously, there's been some developments with some of these newer players, but it's a lot less robust than the consumer lending, certainly in the mortgage lending market.

Then you also talk about, you know, small business loans that are less profitable because particularly, that's a sub-million dollar loan, sub-\$250,000 loan which is what most businesses want. It's been harder for these banks to really make money so there's a lot of head winds for small business lending. Maybe you could just tell us your perspective on how fintech is really addressing these head winds.

**Karen:** Well, I'm a big fan of community banks and community banks have been the go-to for small businesses for a long period of time, but as you just described, there's a whole fed of structural reasons, head winds that are preventing community banks from coming back to this position of prominence. There used to be about.....when I was running the FBA, about 8,000 community banks; we're down to 5,000 and many people.....I talk about various myths, many people say, well if we just, you know, got rid of Dodd-Frank and we got less regulation, community banks would come back and flourish and the fact is that there's some real structural problem.



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It is very hard for a community bank to make money on a loan under \$50,000 and so what has happened is that a gap has emerged in the small business lending market which is small loans to the smallest businesses.

When fintechs had come on the scene, this is the area, of course, that they have began to address. The average Square loan is about \$7,000. It will be very hard in a traditional, you know, relationship banking mode to make money on a \$7,000 loan so I think we need to find ways and community banks are finding ways to participate in this new fintech and to maybe find their position and to use their relationship people in productive ways, but not as the first line information gatherers. We can do better than that with technology.

**Peter:** Right, right. And then so let's sort of tease that out a little bit more. In fact, you talk about in the book....you talk about the small business banker, the future, you even bring up the idea of having specialist banks. That may be community banks that really focus on small business lending almost exclusively, so tell us a little bit about your vision there for this sort of small business bank of the future.

**Karen:** In the book, I take the liberty of making some predictions about how all these might come up, who the winners and losers might be and what the landscape might look like. One of the things that I talk about is the idea that there will be small business-focused banks. I tend to be quite annoyed that small businesses are sort of the poor cousins of the consumer banking market.

When you look at the divisions, you know, there's sort of a wide field of activity around consumers and then they modify the products and send them out to the small businesses. I argue in the book that small business lending is really a very different market and needs small business-focused solutions and technology that take into account these two driving issues. I mentioned information paucity, it is much harder to know what's going on inside the small business and to find out if that small business is creditworthy than it is to figure out whether you should give a consumer a mortgage.

You know, you get ten pieces of data, you can pretty much figure out whether the consumer should get a mortgage, but small businesses are much more complicated. Once you figure out the algorithm for the dry cleaners, it may be totally different for the commercial landscape companies or the restaurants or the producers of, you know, automotive parts.

**Peter:** Right.

**Karen:** So I believe that having vertical specialization would lend you expertise and this actually proves true with an interesting example, Live Oak.

**Peter:** Right.

**Karen:** You know, Live Oak began just with veterinarians and then, of course, I think they did funeral homes and poultry farmers. It also helps in gathering customers because word-of-mouth



spreads around in the sector and you become the trusted expert so I see a future where you could see vertical specialization within the small business banks. They would understand the small business market, they would develop products that really address this heterogeneity, the fact that all the small businesses are different, and they would really gear their products and their services and their advice and their counsel to the small business borrower.

**Peter:** Right, right.

**Karen:** And I think that might be a recipe for success.

**Peter:** That's interesting that certainly some of the online lenders, you have....Kabbage started with eBay sellers, OnDeck had a few targeted verticals when they got going so you can see that there are certain advantages you can have when you focus on a vertical, but I want to touch on another success story, something certainly that...a bank that has gone a different way and that's Eastern Bank.

You talk about them in the book and they are a bank that embraced fintech very early on and they even spun out a tech company basically, I guess, a fintech company out of their bank so tell us a little bit about Eastern Bank and what has been their secret to success.

**Karen:** I'm teaching now at Harvard Business School and I love the story so much that I wrote a case about it which we teach to the MBA's and really the key player in the case, our protagonist, Bob Rivers, the CEO of Eastern Bank, is a key factor in this story and their success.

Eastern Bank is a 200-year old mutual bank, it started in Salem, Massachusetts back in the days of the witch trials and it started with a community focus and each of the people who got a loan, just like a mortgage, had to come back and they had to work in the bank for an hour a week so that the other community members could get access to lending. That heritage has really defined the bank.

Bob Rivers realized that he was going to serve his community of small businesses and he was a big SBA lender, small business lender, that he would have to....as he said it, embrace technology and disrupt themselves, not way to be disrupted, but go out, find innovation and disrupt themselves. Now his leadership was key to this.

It took a little while for him to get his senior staff on board, but when they looked into the borrowers' account and saw that they were paying interest to fintech loans that they had taken and these were customers of Eastern that had not even been offered an Eastern loan clearly were quite creditworthy. He said, you know what, we have to develop our own solution.

**Peter:** Right.

**Karen:** He attracted Dan O'Malley, they developed a solution over a couple of years so it was developed inside the bank and then they allowed Dan to spin it out and it is now providing, and



full disclosure, I'm actually an investor, enumerated the spin out, but it is providing access to this kind of sort of technological front end to other community banks.

So I think this is terrific because we want community banks to be able to get up to speed fast. They don't have to reinvent the wheel, create their own technology. We want a plug-in solution so that they can provide this fast solution to their own customers and that's one element of what I hope will be a very broad and sweeping set of solutions for all kinds of small business owners who want to engage with all kinds of different institutions; traditional ones or new ones.

**Peter:** Right, right. And just on that, I want to bring....obviously, you were Head of the Small Business Administration for several years and, you know, the Small Business Administration.....

**Karen:** Five, a long time.

**Peter:** (laughs)....okay, they primarily work with banks when they're doing this guarantee that you've talked about. There was an interesting Op-Ed the other day in American Banker, it was by the Head of Funding Circle USA, talking about you know what.....I know that there are certain non-banks that do have access to these SBA guarantees, but not many and given the way it's changed....I know you no longer have authority at the SBA, but I'm curious to get your perspective. Shouldn't the SBA be partnering more with fintechs than ever before?

**Karen:** Well, as you might imagine, I am a big fan of the SBA and its mission and its mission is to provide access to credit to small businesses who cannot, otherwise, access that credit, but are creditworthy. What that means is, if you can get a loan from a bank, regular bank or fintech, without an SBA guarantee, then you should, that's how the market works, but in many, many cases a small business owner comes to a bank and is just not quite needing the credit threshold.

So the bank asks the SBA, would you guarantee this loan, maybe 75% of it and the SBA will give approval and that will allow the bank to make the loan with some skin in the game but not all the risk. We know that that fills an important gap in the US economy and we actually know the size of that gap because the SBA has a portfolio of \$100 Billion of these loans.

We know these are good loans because the loss rate on the SBA portfolio is less than 5% so \$95 Billion worth of loans are made in this country that would not otherwise be made to good important small businesses which, by the way, the SBA over indexes in underserved minorities and women on businesses so this is a really important program that fills the gap. The other thing that's good about it is that because the loss rate is not high, the guarantee cost that you, as taxpayers.... almost no money.

If this is the role of the SBA then, of course, it should be engaged with all of the lenders who are, you know, the conduit to these important gaps in the marketplace, but it's also the role of the SBA to be very, very careful with taxpayer money so it is up to the fintechs, I think, to prove that their portfolio should be worthy of an SBA guarantee because we're playing with, you know, your tax dollars or my tax dollars. I think that's the place that is a sequence and my guess is that



will absolutely come about as the fintech market stabilizes and becomes a regular part of American small business lending.

**Peter:** Right, because, as you say, there's a lot of these fintech companies that have limited track records and there are some that focus on the higher risk side of the market where defaults are way over 5%, they're well into double figures in some cases. They might not be appropriate, although....even with some of those companies like they would argue that they have a portion of their portfolio that probably would be suitable, just not all of it. That's good to hear, I feel like this is a program that I would like to see extended and I know that the government does not move quickly, but I'm glad to hear that you're on board with it.

Anyway, I want to move along and talk about a couple of other things now. I went through your book in some detail, actually I went through the PDF that you sent me a while back and I was looking at how many times you mentioned Amazon, PayPal and Square and you do mention them throughout the book. But I found it interesting that Amazon gets mentioned more than twice as much as either PayPal or Square and I wanted to get your take on all three companies. Specifically, you do seem to focus more attention on Amazon, are they ....do you think these companies and maybe that company, in particular, is going to be a very big player or maybe even the biggest player in small business lending in the future?

**Karen:** Well, I didn't actually count so that's an interesting observation. I am a big fan, particularly of Square, because Jack Dorsey came and worked with us at the SBA when he launched Square and he and I did National Small Business Week before he even went back to run Twitter so I've been sort of with Square since the founding. But Amazon is, without a doubt, going to be one of the critical small business forces in the US and I'm sure you know that they are already a major small business lender and PayPal and Square have insight into a lot of information because they see the receipts on a real-time basis and so they will be important in the equation.

One of the questions is, what happens to the businesses who don't have a retail focus, who don't have a Square device, who don't sell products through Amazon; they might be a service provider and where do they come in in the market. So although I believe these technology companies and others, like Intuit, I see them as really important thought leaders and drivers of the change as they have the head, of course, in their whole history.

But I also don't think that they will take over the entire market; I think that the JP Morgans and Wells Fargos and Bank of Americas are going to make sure and the community banks are going to also play a role as well. As I said, you know, really innovative players like vertical banks so I think the landscape is open, you know, there's real opportunity, but without a doubt, for a certain segment, the Amazons and the Squares will be critical.

**Peter:** Yeah, yeah, okay. So I want to talk about another big topic and I know that we're running out of time, but I wanted at least to spend some time on this and that is, regulation, you have a couple of chapters in the book dedicated to it. Maybe we could start off with borrower



protections and this has been obviously in California, there has been a bill passed there to help the small business lending disclosures....that small business lending disclosures have to be provided, but what are your thoughts on borrower protections when it comes to small business owners.

**Karen:** Well there are two full chapters, I will say, in the book on regulation and you and I do find it interesting and I actually think it is a critical sort of underpinning of understanding what's going to be veering into the future of small business lending. As you mentioned, there are some critical worries. Small businesses have really fallen through the cracks of the regulatory system as it exists in the US today; I call it a "spaghetti soup."

There are seven regulators and not one of them, up until the OCC recently said they would, has the ability to charter a fintech and most worrisome to me, small businesses are not protected by the Consumer Protections and disclosure requirements of the CFPB, the Consumer Financial Protection Board, and I think that's wrong. Small businesses, the Fed surveys approved this, and I made quite the case in the book about the fact that small businesses really require the same kind of protections as consumers.

One of the ways I prove it is I take the Fed focus group questions and I showed them to Harvard Business School students and alumni and a whole set of people and I say, you know, tell me, interpret this loan, tell me what the interest rate is and I get numbers from, you know, five to 30 to 50 as answers. It's very hard to interpret a loan. In loan documents there's all kinds of hidden fees and costs so why can't we do what we do for consumers and have a smart box, a disclosure box, and just tell them that this is what all the costs are. So that seems to me a no brainer.

**Peter:** Okay, so then given the reality of the situation with any....you have a great diagram in the book that just sort of shows all the regulators with loans going all over the place, how the small businesses are regulated, but given that you did spend time in government, you know what is realistic, but what should regulation look like if you're really going to do something that is better than what we have now?

**Karen:** Well streamlining and simplifying this process is, of course, critical. Actually, the US Treasury put out some recommendations which were very thoughtful in this regard.

The other thing that's coming though that no one has really figured out is all of the European open banking activity and privacy laws will be the critical aspect of regulation going forward. If you look at what I've described in the book as most promising really transformation that will happen to small businesses and to small business lending, it really lies in this ability to gather data, to suck it up to these API's and create a small business dashboard and know from that dashboard how the businesses are really going to do.

The ability to do that exists now because we have infrastructure providers like Plaid and Yodlee who will pool all that data from your credit card provider and your bank and your turbo tax



account and your QuickBooks accounts all up into a dashboard. I call this, by the way, Small Business Utopia.

It's this notion that not only your banker can have a vision of what's going on inside your business, that you as a small business owner, you could have that as well and in order for that to occur, we have to pay attention to open banking. And whether or not we want to adapt that as part of our regulatory framework here in the US, I believe that that is going to be critical to creating this open innovation environment which will, we hope, create all these new products and services that are part of Small Business Utopia.

**Peter:** Right and you provide there a fascinating example in your book about how this actually would work in practice. I think it's a coffee shop owner from memory.....

**Karen:** (laughs) Yes.

**Peter:**.....that you provide about whether she could buy.....

**Karen:** That was the coffee shop owner, yes. So I have a made up story in the book about the coffee shop owner, but I have to tell you, I was walking down main street in my hometown in Brunswick and a young woman and her partner have opened one of those micro breweries and I was describing the coffee shop owner and the Small Business Utopia in the dashboard and she said, you know, this would be perfect.

I go home at night, I stay on my bed, I open my laptop, I pull up my bank account, I pull up my QuickBooks account, I open my iPad and my phone, I have six or seven screens open and in my head I'm trying to create an Excel spreadsheet that tells me how's my cash flow going to be, do I need a seasonal loan?

To me, we can solve this problem, technology can solve this problem tomorrow and so I believe as we do, we will have more small business owners. We will have more small business owners who succeed and I think this could really have an enormous impact on our economy and on the ability of people to achieve the American Dream.

**Peter:** Yeah, yeah, indeed. Just on that, last question, you do paint a pretty rosy picture of the future of small business lending in the final chapters of your book, but I want to just maybe close with what are some of the things you're optimistic about and what are some of the things you're pessimistic about when it comes to small business lending in the future?

**Karen:** I am an optimist so I will admit that. I wrote this book because I really believe that there is an opportunity, that in a sector which has perhaps been forgotten about and a little bit left behind, the small business owner with their pain points of accessing capital are now going to enter new possibilities of being well served as innovation takes over this market.

I want to, in any way I can, through this book and through the efforts of places like LendIt see how we can create an open landscape where large tech companies like Amazon for this



solution and old fashioned banks like Eastern or large ones like JP Morgan, you know, also competing and new entrepreneurs and innovators push them by offering new products and online vertical banks, all of it geared around the ability of technology to solve these critical frictions in small business lending..... this informational paucity, this heterogeneity, these things that make small businesses hard to lend to, hard to understand.

If we do this right and we create a regulatory environment that allows for open banking and access to these data and we don't have data monopolies, then we have the opportunity to fuel this critical part of our economy and also the part of our economy that creates economic mobility and this is sort of my history. You know, I come from a family of immigrants who started small businesses so I believe in the American Dream and I think technology gives us more possibilities, more promise of that if we do it right.

**Peter:** Okay, that's a good note to end on. I certainly think it's exciting times now. I really appreciate your coming on the show today, Karen.

**Karen:** Thanks so much, always a pleasure.

**Peter:** Okay, see you.

**Karen:** Bye.

**Peter:** Before I close, I just want to give you a heads up on the timing of the launch of the book. We're recording this on the last day of February and the electronic version of the book will be launched on March 14th and the hard cover is being launched on April 4th. I will have a link to the page on Amazon where you can go and pre-order the book.

Before I go, I just want to touch on Small Business Utopia, as Karen puts it and I think we really are nowhere near there yet, but I know there are several companies that are working on creating exactly what Karen describes where you've got basically a dashboard where all your information is being pooled in from different sources and you have a complete picture of the financial condition of your business.

Now I think it's not going to be done overnight, but given the fact there are several companies working on this, I really expect within a year or two there will be several good options that small business owners can have that will be able to give them a much better picture on the overall view of their business.

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

Today's episode was sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's happening April 8th thru 9th, at Moscone West in San Francisco. It's going to be the largest fintech event held in the Bay Area in 2019. We'll be



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