Blog

Industry Profile – Karen G. Mills

December 14, 2017 · David Beaver, Director of Content & Communications

Senior Fellow at the Harvard Business School

Karen G. Mills is arguably the leading authority on small business and small business lending in the United States. A former member of President Obama's Cabinet as Administrator of the U.S. Small Business Administration (SBA) from 2009 to 2013, Mills played a pivotal role in reversing the rapid decline in credit availability for small businesses during the financial crisis and *Great Recession*.

For many people involved in the online lending industry, their introduction to Karen Mills likely came via the 2015 Lendit Conference, where she presented the results of her most recent research, a working paper she co-authored in 2014 entitled *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game*.

She has since published a follow-up paper, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation*, and is now working on a much-anticipated academic book on small business' impact on the economy, access to capital, and how technology is transforming financing and other opportunities for small businesses.

There is a global explosion of innovation and competition occurring across the financial services industry, and the pace of change is accelerating. In this kind of environment — with an overabundance of marketing spin and a lot of capital at stake — it can be easy to forget the mission. To focus more on 'startup culture' and the next 'Unicorn' instead of who all this new technology is supposed to benefit.

Not so for Karen Mills. She's dedicated her career to helping small businesses, from analyzing the importance of small businesses and entrepreneurs to our economy, to understanding and addressing the daily challenges they face and ensuring they continue to receive the financing and support they need to thrive. I recently had an opportunity to speak with Mills about her motivations as well as her thoughts on the current state of small business lending and what the future may hold for small businesses and fintech.

Small Business in her Blood

"My Grandpa Jack basically taught me entrepreneurship," she recalls. Small business and entrepreneurship ran deep on both sides of Mills' family. "Here I am teaching at Harvard Business School, but I really learned by hearing his stories over and over."

"In Russia, Grandpa Jack and his family made leather uppers for shoes. They'd go to market in a horse-drawn cart." Upon emigrating to the United States in the early 1900s, her grandfather worked at a GE light bulb factory in Lynn, MA, and did a stint at a tannery. After founding a baby shoe business, he started his own textile business, making women's hosiery and socks for World War I soldiers. The other side of Mills' family, also from immigrant stock, ran a factory supplying boxes for Tootsie Roll. "So I grew up with these businesses that really represented the American dream. You come to this country with nothing, you build a business, and you create a lot of jobs, you provide for your family and your extended family."

> "Small businesses are a path to the American Dream. That was true for my family, and it's been true for as long as our nation has been around. This belief that we need to make sure everyone has a chance to achieve the American Dream is what motivates me to try to make sure that small businesses flourish in this country."

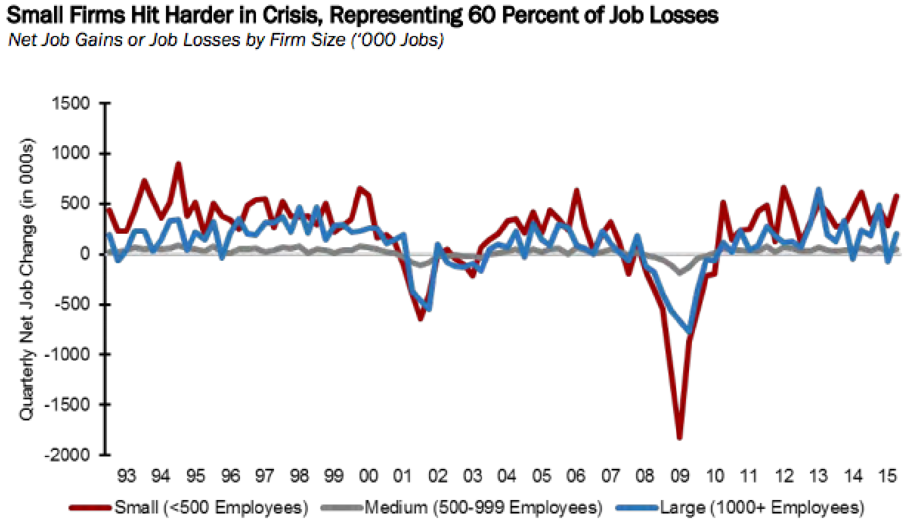
But Mills recalls initially thinking this entrepreneurial spirit didn't apply to her as she studied at school and then headed to work at larger companies like General Foods and McKinsey. That changed when "about seven years later, I ended up having the opportunity to buy an industrial business in injection molding and metal stamping that I largely understood because of the businesses my family owned. I'd practically grown up on the factory floor," she laughs.

From there, Mills continued to own and invest in small companies, and that experience gave her insight into not just small manufacturers, but also the numerous small businesses that are a part of the fabric of communities all across the country.

"About 15 years ago my family moved from New York City to Brunswick, Maine, where I saw the essential role of small businesses in communities even more clearly. In Brunswick, I know most of the shop owners on Maine Street, as do my neighbors. They support the community activities, like Little League and other initiatives. This is very much how America works and we can't take this for granted. Small business is critical to the economy and our communities, and it's under pressure."

Heading the SBA in a Time of Crisis

Joining the Obama Administration and National Economic Council as the head of the SBA in 2009 was a pivotal moment in Mills' career. "I went to work for the President in that first quarter of 2009, in the really difficult part of the financial crisis," she recalls. "It was quite clear that the credit markets were not functioning. What wasn't as clear at the time was the devastation small businesses were suffering due to a lack of credit." Mills later quantified this impact in the chart below from her 2016 working paper. Small businesses alone shed 1.8 million jobs during that first quarter of 2009, with the credit freeze playing an outsized role.



Source: Bureau of Labor Statistics, Business Employment Dynamics.

"Being new to government, I didn't know how it worked. I just figured I was supposed to solve the problem," says Mills. "I was a venture capitalist, so I thought I should do something bold. We came up with a plan to raise the SBA loan guarantee rate to 90%." President Obama's economic team signed off on this unprecedented move, and it generated immediate results. "Within six months, we got 1,000 banks to return to SBA lending," Mills says. "We also reduced the paperwork and streamlined processes, all which contributed to three record years of SBA lending."

"I also gained an appreciation for how difficult it is to make sure that the voice of small business is heard," Mills said. "Large business certainly has a seat at the table; various industries have a voice in U.S. economic policy. But small business owners are busy running their businesses, and despite rhetoric to the contrary, there isn't always a consensus among policymakers about the importance of small businesses to the economy."

> Mills noted that one reason small businesses often lack a voice in U.S. economic policy is the tendency to conflate different kinds of small businesses, from venture-backed startups to supply-chain providers to the gig economy to Main Street retailers. This often leads to policy that undervalues the contribution of small businesses.

For example, Mills recalled the government assistance to the Big Three automotive companies during the financial crisis. She pointed out an equally important, but often overlooked group, impacted by the crisis: "Those small businesses in the automotive supply chain supporting factories like Chrysler in Kokomo, Indiana, where I visited shortly after joining SBA in 2009." As proof to their importance, she cites recent work she co-authored with MIT professor Mercedes Delgado on the impact of supply chain small businesses as creators of well-paying jobs, including services sector businesses, on the United States economy.

One of the big contributions she was able to make was to continuously think about economic policy decisions with an eye to all of America's different kinds of entrepreneurs, whether they be the high-growth innovators, suppliers, or the new small business owner on Main Street.

The Current State of Small Business Lending

"What's the current state of small business lending? Improving, but far from perfect. During the crisis, the banks stopped lending, credit froze, and small businesses — who don't have other methods of accessing capital and are therefore very bank-dependent — really suffered," Mills noted. The SBA programs led by Mills improved the situation, as did cyclical macroeconomic improvements and the rise of digital lenders.

"In the first white paper, we describe a whole range of cyclical and structural issues around the decline in community banks, including the increases in regulation, and the cost structure of lending that renders it unprofitable to make loans under $250,000, and certainly under $100,000," she said. "And it turns out that more than 70% of small businesses want a loan under $250,000, and many of them want a loan under $100,000."

"Enter technology," she continued, noting that digital lenders helped address the cost structure issue by streamlining the loan application process and helping reduce operational costs. "It created a more automated experience, which is very customer-friendly. It's quick; it's easy to access, it responds in minutes, the money is in your account within hours or days. And this was much needed because, at the time, banks were not delivering a good customer experience," Mills said. "The minute small businesses saw this better experience; they rushed to try it, but it didn't take long for banks to wake up and realize that they could duplicate this customer experience."

Structural Issues Linger

Despite these improvements to the lending process, Mills said, structural issues linger. She applauds the positive innovations digital lenders have introduced to small business lending, but on the regulatory side, she's concerned about protecting small businesses against bad actors.

In her research, she described a "spaghetti soup" of financial regulators who all claim some stake in U.S. small business lending oversight, but none of whom seem to have a clear mandate to protect small business borrowers. In fact, transparency laws like the Truth in Lending Act do not even apply to small business lending. In other words, despite overlapping and sometimes conflicting guidance from multiple regulators, small business borrower protection still falls through the cracks.

Mills points to the United Kingdom as a regulatory model worth watching and possibly imitating in the United States.

“While the U.S. had 5,000 community banks that the SBA could spark back into lending with the right incentives during the financial crisis, the U.K. had no SBA equivalent and just four major banks. And essentially, all those banks were failing”, Mills said. “So the U.K. entered the financial crisis operating at a considerable disadvantage.

Fast forward to now. Mills toured the U.K. around the 2017 Lendit Europe conference, and she appreciated the way they are trying to both protect and regulate while creating more access and opportunity for innovative small businesses. She notes that among the key steps, the U.K. created the British Business Bank (BBB), which has facilitated the launch of new “challenger banks” to create more points of access for small businesses. Additionally, the BBB has as part of its mission the collection of data around small business lending so that policymakers are better informed about what’s working and potential gaps.

Another notable post-financial crisis step was the focus on innovation. “The U.K.’s main regulator, the Financial Control Authority (FCA) operates under what they call a competition remit, which gives them a mandate to encourage competition in the market. As a result, following the recession, they launched an innovation sandbox where fintech companies can try out various approaches under the supervision of regulators,” Mills said. “It’s a protected environment that lets startups focus on innovation and growth, while the FCA can determine if they should be authorized or registered with them." It's a thoughtful approach.

The Future of Fintech and Small Business

"There is a hierarchy of needs for small business owners," Mills described. Small business owners have a scarcity of time. So providing services more efficiently to them is very valuable. They worry about cash and the 'bumpiness' of their cash cycle. And the most import thing to them is sales.

Mills explained that one of the main reasons small businesses go out of business is an inability to manage cash flow. "It's bumpy and hard to predict, and most small business owners don't tend to come from a background where they have been trained in financial management." Recent data from the JPMorgan Chase Institute showed that small businesses have an average 27-day cash buffer. "If customers pay late, they can run out of money and go out of business. Amex, for example, is working on offering an affordable financing product that helps small business smooth out these bumps by making payments for you for 30, 60, or 90 days."

"You can see a whole set of ways that fintech is already opening up opportunities for small business," Mills observed. She cites merchant services provided by firms like Square that allow small businesses owners like food truck operators or sellers at a farmer's market to conduct commerce and grow.

> "We're very much in the first phase of innovation. Next, imagine if they could also tell a small business owner something about their customers that helps them increase sales or help them to better manage their finances."

The continued development and impact of Artificial Intelligence (AI) is widely cited as one of the most important trends to watch, in not only fintech but technology in general. For small business, Mills sees the opportunity for not just improving credit underwriting and the ability for businesses to receive much-needed financing but also sees the other benefits that AI and new approaches to data may bring.

"The emergence of AI and big data is an important development," Mills said. "It has the potential to help meet all of a small business owners' needs. A single provider with access to the right data and technology could now process a loan quickly through automated underwriting, expand the credit box with alternative data, look into a customer's cash cycle data and provide just-in-time financing at the right price, and provide the small business owner with insight into their customers."

However, explained Mills, there are significant risks. “I read two conflicting papers in just the last couple of days. One came out from the Fed and found that the use of alternative data sources in consumer lending has helped some borrowers receive lower-priced credit. And then another I saw said it may inject certain biases into credit decisioning.”

> Which brings us to the proverbial ‘gorillas in the room’ and the comments that have been made by Mills and others about the likelihood of big-tech players stepping into this market and dominating it.

“In China, we’ve already seen that large e-commerce platforms can become large players in fintech. In the U.S., companies like Google and Amazon have the potential of being a very important source of both financing and new financial services for small businesses – and consumers,” Mills said. These businesses not only gather a lot of information that would enable them to provide credit to more small businesses, but they also have critical information about consumers, which Mills noted “could enable them to provide other kinds of products and intelligence to help small businesses.”

"Having access to tools and dashboards could provide small business owners with insights to help them manage their cash better, manage their business better, make better decisions about growth, and hopefully continue to hire more people and have greater longevity. We are in a transformative moment, and there is enormous potential to help small businesses. The key question in my mind is whether it will transform in a way that enables small businesses to do what they do best – support the American Dream, grow the economy, and create jobs."

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