MONEY FOR LESS. RESPECT FOR FREE.
Blockchain may give us opportunity for real systemic change.
By: Michelle Corson

For over 5,000 years, long before we had money, people borrowed from each other to satisfy their needs. Contrary to popular belief, bartering was not the only way our agrarian ancestors financed their work. They made contractual agreements with each other with the same kinds of covenants we routinely use today. The difference between then and now is how we evaluate the likelihood of repayment.

It wasn't until the 1950s, with the advent of the Diner's Club credit card, that we began to score prospective borrowers using formulas, which over the last 70 years have morphed into complex and secretive algorithms. Credit is simply a proxy for trust, and, in the past, we used to price the degree to which we believed someone would pay us back by taking the time to know that person.

A quaint concept, you say?

Our attention spans have become so short that we only have 30 seconds to make our point. We don't have conversations now. We make "fast pitches." Our society requires immediate gratification. But interestingly, the models built on instant decisions prove inadequate to the task when the economic sands are shifting beneath us quickly.

Decisions based on credit scores use inductive reasoning – there is no time for further inquiry, so we assume that the past predicts the future by relying solely on these indices. But credit is a lagging indicator – it can be months old. Less than 20% of subprime lenders even take the time to verify income, and we know how that ends. (Remember the subprime mortgage crisis?)

Blockchain at its core is about trust.

Subprime lenders price their loans high because they have a high expectation of default. Consumers with weak or non-existent credit are deemed risky, and the loss rates with these loans suggest this is a reasonable approach. What happens if we shift this paradigm? What happens when we have a low expectation of default, despite what a credit score indicates? Because of the "consensus of truth" inherent in blockchain, we think there is a compelling case

to be made for the creation of a reputation index within a collaborative blockchain that can transform credit-weak or credit-invisible consumers into desirable borrowers.

Americans have $1.2 trillion in open auto loan balances in 2020, with approximately 40% of all originations made to less than prime consumers. Most of these loans are securitized with investor returns of 1 – 3% (per S&P data on securitized pools). Expected cumulative loss rates within these portfolios exceed 30%. If we take a different approach, what we refer to as a borrower equity-focused loan, using character-based underwriting that provides a low expectation of default, we can charge subprime consumers 50 – 60% lower interest rates, driving payments down by about 20% over the conventional subprime lending approach. To illustrate, a borrower with a 525-credit score would be considered deep subprime by traditional lenders who would view this loan as very risky with a high probability of default. This borrower would pay an interest rate somewhere between 18 and 22%. If they financed a car for $15,000 with a five-year term at 20% interest, their payment would be $397. If we took just a little bit more time to learn enough about the borrower to understand their risk profile better and viewed them as about a 50/50 chance of default, we might be willing to make that same loan for half the rate. Under the same scenario at 9.75%, their payment drops to $316, a 20% reduction. Over the five-year loan period, the savings on interest alone is about $5,000.

The loan is only part of the story. Since a car is a significant purchase for a working family, making sure they avoid buying the wrong car is equally important. We pair a favorable loan with vehicle selection assistance. We can aid further purchasing power by ensuring the vehicle is reliable, under warranty, easy to maintain, inexpensive to fuel, and holds its value. One of the primary reasons for default is purchasing a bad vehicle, especially one that is not under warranty. When the average American cannot put their hands on $400 in the event of an emergency, how do they manage a $2,000 transmission repair and continue to make their car payments? Focusing their car purchase on needs versus wants is easier with a vehicle purchase coach, creating an extraordinary difference in outcomes. In some cases, the financial benefit can approach as much as $20,000 over the term. A blockchain that establishes an immutable record of a vehicle's life events contributes value to the purchaser and has the potential to monetize the vehicle's telematics, as well.

The magic of blockchain becomes most apparent in loan servicing because of the value of the timestamp. A borrower's credit is strengthened through on-time payment performance on a loan. If these payments were recorded on chain and reported to the credit bureaus in real time through smart contracts, the inherent credit scoring latency disappears. If the consumer's other positive financial activity that is not typically captured in credit scores, such as rent or utility payments, could also be reported on a blockchain, the consortium of users could build the consumer's trust factor.

Finally, blockchain's reduction of friction can free-up resources to allow for a borrower-first loan servicing strategy. Traditional lending, where banks have no knowledge of their borrower's circumstances, uses automatic repossession triggers based on predetermined delinquencies. If we assume there will be a low degree of default and we work with our borrowers to that end,

without automatically repossessing their means to reach their jobs, the opportunity to build credit and avoid the devastating impact of losing a car is possible. It can put low-income consumers on an upward economic trajectory instead of one that leads to credit deterioration, job loss and even potential homelessness. What traditional lenders will find is that this approach builds tremendous loyalty with their customers who will redouble their efforts to get caught up on their payments with just a little bit of grace.

While we do not have a blockchain-based system yet, we know this lending approach works. We have created this model inside a loan fund seeded by impact investors. The fund is designated as a Community Development Finance Institution by the US Treasury (making it easy for banks to partner). Because this is a private ESG impact investing fund (our cars are 35% better for the environment in terms of greenhouse gas emissions and fuel consumption), there is greater latitude to make loans unconventionally. The investors who have funded these loans receive the same market-rate returns of 1 – 3% that the securitization investors receive, but the loss rate is three times better. Under this model, the capital stewardship is much more robust, and the adverse impact on families is minimized.

With blockchain we have the opportunity to scale our work. In an inherently inefficient approach to loan underwriting, origination and servicing, even small gains in efficiency matter. Moreover, when offering a car loan that is as deeply discounted to market as ours is, removing intermediaries to bring down costs makes it easier for us to achieve our mission. The larger we can become -- the more families we can help -- there is a real opportunity for us to demonstrate to the traditional lending community that this approach is scalable, fundamentally changing the way we look at trust.

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Michelle Corson is founder and CEO of a family of companies, including On the Road Sustainability Funds, an ESG impact investment fund making affordable loans on fuel efficient, reliable cars for working families. A car lover, she has launched several other auto-related social enterprises, including On the Road Garage, which is building the workforce of the future in smart car technology for vulnerable populations. She has contributed to the white papers produced by MOBI and is the author of "Freedom of Motion: Working Families and the Transportation Revolution," which is available on Amazon, benefiting the vehicle purchase programs of the nonprofit On the Road Lending.