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CHAIRWOMAN

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RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–0515

MEMORANDUM

To:	Members, Committee on Small Business
From:	Nydia M. Velázquez, Chairwoman
Date:	September 9, 2020
Re:	Full Committee Remote Hearing: "Transparency in Small Business Lending"

The Committee on Small Business will meet for a remote hearing titled "Transparency in Small Business Lending." The hearing is scheduled to begin at **1:00 P.M. on Wednesday, September 9, 2020 virtually via the WebEx platform (information to be provided)**.

The hearing will allow Members to explore the challenges and opportunities for small businesses presented by innovations in financial technology ("Fintech"), with a focus on access to capital. Members will hear from lenders, industry advocates, and academics regarding the policy issues Congress and regulators must confront in assuring a fair but efficient small business credit market by requiring better disclosure and increased transparency specifically in the Fintech space.

Panel:

- Ms. Luz Urrutia, CEO, Opportunity Fund, San Jose, CA
- Ms. Yanki Tshering, Executive Director, Business Center for New Americans, New York, NY
- Mr. Adam Levitin, Professor of Law, Georgetown University Law Center, Washington, DC
- Mr. Michael Hiles, Founder and CEO, 10XTS, Cincinnati, OH

Background

Small businesses interact with Financial technology companies ("Fintechs") in various ways. Innovations in Fintech can accelerate capital access for small-dollar borrowers and more generally improve business operations for small firms. However, many observers have argued these gains must be weighed carefully against the risks associated with these technologies, especially for traditionally underserved entrepreneurship communities when it comes to accessing capital.[1] These observers have argued that due to a lack of transparency in the loan underwriting process, it is difficult to assess whether these Fintech underwriting methods have a discriminatory impact (whether intentional or not) on communities of color.[2]

[1] *See, e.g.*, Office of Congressman Emanuel Cleaver, II, *Fintech Investigative Report* (Aug. 2018) https://cleaver.house.gov/sites/cleaver.house.gov/files/Fintech_Report_1.pdf [hereinafter Cleaver Report].
[2] Cleaver Report, *supra* note 1.

Meanwhile, the COVID-19 pandemic is causing widespread economic hardship across the U.S., affecting financial conditions and impairing the flow of credit particularly to small firms. Unfortunately, even prior to the pandemic, small businesses were vulnerable to irresponsible lenders. According to the Federal Reserve (Fed), small business disclosures used in today's marketplace often leave business owners unable to make informed comparisons about the price of financing.[3] This has significant consequences for small businesses, as additional research has found that the average monthly payments charged small business owners to be almost double what these small businesses could afford to pay.[4] One article published by *Forbes* in 2015 compared online small business loans to subprime mortgages.[5]

Small Business Access to Capital Landscape

Small businesses make up a significant portion of the United States economy, with the 31.7 million small businesses making up 99.9 percent of all firms and employing 47.1 percent of all private sector employees.[6] Small firms are also a key factor in job creation and economic growth, creating 1.6 million net new jobs in 2019.[7] The smallest firms were the strongest job creators – firms employing fewer than 20 employees added 1.1 million of those net new jobs in 2019.[8]

Access to affordable capital remains a significant barrier to start-up and growth for millions of small businesses. The Federal Reserve's 2020 Small Business Credit Survey (the 2020 Fed survey) issued findings showing demand for small business credit remains strong, but that gaps remain in fully meeting financing needs. For example, the survey results showed consistent demand for new financing with 43 percent of firms applying for new capital in 2019, in line with the 43 percent reported in 2018.[9] Moreover, 51 percent of respondents reported experiencing having unmet financing needs, due either to a financing shortfall or not applying out of debt aversion or discouragement.[10] This is important because input costs appear to be on the rise – 76 percent of respondents reported increased input costs over the prior year (up from 73 percent in 2019).[11]

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[3] Board of Governors of the Federal Reserve System, *Browsing to Borrow: 'Mom & Pop' Small Business Perspectives on Online Lenders* (Jun. 2018) https://www.federalreserve.gov/publications/files/2018-small- business-lending.pdf.

[4] Opportunity Fund, *Unaffordable and Unsustainable: The New Business Lending on Main Street* (May 2016) https://www.opportunityfund.org/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/.

[5] Shin, Laura, *Why Online Small Business Loans Are Being Compared To Subprime Mortgages*, FORBES (Dec. 10, 2015) https://www.forbes.com/sites/laurashin/2015/12/10/why-online-small-business-loans-are-being-compared-to-subprime-mortgages/#6064b6ca9288.

[6] U.S. Small Bus. Admin., Off. of Advocacy, *2020 Small Business Profile – United States* (May 20, 2020), https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04144224/2020-Small-Business-Economic-Profile-US.pdf [hereinafter SBA Advocacy].

[7] SBA Advocacy, *supra* note 6.

[8] SBA Advocacy, *supra* note 6.

[9] Federal Reserve Bank, *2020 Small Business Credit Survey: Report on Employer Firms*, https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2020/2020-sbcs-employer-firms-report [hereinafter Fed Small Business Survey 2020].

[10] Fed Small Business Survey 2020, *supra* note 9.

[11] Fed Small Business Survey 2020, *supra* note 9.

Notably, the Fed survey also issued findings regarding the entities from which small business sought credit. Applications to online lenders continued to trend upward: 33 percent of applicants turned to online lenders in 2019, up from 32 percent in 2018 and 24 percent in 2017.[12] This growth continued despite lower applicant satisfaction with online lenders compared to satisfaction levels with large and small banks (another trend that has continued from 2018 into 2019).[13] Medium- and high-credit-risk applicants were most likely to apply to an online lender (51 percent), compared to large or small banks (34 and 32 percent, respectively), and even less likely to apply to a credit union or community development financial institution (CDFI) (9 and 4 percent, respectively).[14] These trends reinforce this Committee's need to continue monitoring fairness in Fintech lending.

<u>Overview of Online Small Business Lending</u>

Due largely to technological advances, online lending has become an increasingly popular method for small businesses to obtain capital. Marketplace origination experienced an annual compounding growth rate of 163 percent between 2011 (when originations were $473 million) and 2015.[15] One market identified $386 billion in personal and small business lending that potentially could migrate from banks to marketplace lenders between 2020 and 2025.[16]

Small firms are also likelier than larger ones to use online lenders. The Fed's 2016 Small Business Credit Survey found that while only 12 percent of respondents with revenues over $1 million applied to an online lender, 26 percent of respondents with revenues less than $1 million applied to one.[17] Online lenders are more likely to lend in small amounts and have shorter repayment periods compared to traditional bank loans.[18] With the size of the average online loan being relatively small, these financial products have been typically geared toward small businesses.

Instead of reviewing financial statements and documents, or holding in-person meetings with an applicant, online lenders use various data points such as cash-flow, direct deposits, shipping, and even social media data to further understand the creditworthiness of a small business.[19] With so much data readily available to assess a small business' creditworthiness, approval decisions for online small business loans are almost instantaneous. Although a traditional bank term loan can take up to 60 days for approval and financing, small business online lenders can send funds to

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[12] Fed Small Business Survey 2020, *supra* note 9.
[13] Fed Small Business Survey 2020, *supra* note 9.
[14] Fed Small Business Survey 2020, *supra* note 9.
[15] Cong. Research Serv., *Marketplace Lending Fintech in Consumer and Small-Business Lending*, R44614 (Sep. 4 2018) [hereinafter CRS R44614].
[16] CRS R44614, *supra* note 15.
[17] Federal Reserve Bank, *2016 Small Business Credit Survey*, https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.
[18] Usman Ahmed, Thorsten Beck, Christine McDaniel, and Simon Schropp, *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, MIT Press, INNOVATIONS: TECHNOLOGY, GOVERNANCE, GLOBALIZATION 38 (2016) http://www.mitpressjournals.org/doi/pdf/10.1162/inov_a_00239.
[19] Karen Gordon Mills, *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game*, Working Paper 15-004, HARVARD BUSINESS REVIEW (2014) http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf.

small businesses in as little as 48 hours.[20] The convenience of online lending platforms has also helped in areas of the country that would struggle to obtain credit otherwise.

Though small business loans can be an effective method of acquiring capital quickly, the cost for online loans often exceeds those of traditional banks. A traditional bank loan typically has an average annual percentage rate of charge (APR) ranging from 4 to 13 percent.[21] While the exact interest rate of an online loan varies depending on factors such as creditworthiness, revenue, time in business, and other factors, APRs for online loans can range from 7 to over 100 percent.[22] In many cases, loans at this high interest would be illegal under many state usury laws, but those laws are circumvented by predatory lenders who operate a "rent-a-bank" scheme. Under this scheme, the loans will be originated by a bank per guidelines set by the online lender.[23] The loans are then sold almost immediately to the online lender under a standing agreement to purchase all or almost all such loans.[24] Loan disbursement will generally be by the bank, and loan payments might be made to the bank, but the bank is not the real economic party in interest nor is it exercising meaningful control over the design of the loan product.[25] The point of this sort of rent-a-bank transaction is for the non-bank fintech to avoid the application of state usury laws by sheltering in federal law's preemption for banks of usury laws and certain other consumer protection laws.[26]

According to the 2020 Fed Survey, small businesses are aware of the higher costs, as 57 percent of respondents reported "high cost or interest rate" as a challenge with online lenders.[27] Furthermore, over the past five years, respondents have reported the lowest level of satisfaction over time with online lenders compared to other lenders.[28] The higher costs and relative low satisfaction associated with online lenders highlights the need for increased transparency as online lending continues to grow, especially as in-person banking has declined in the COVID-19 era.

Online Lending Business Models

There are several types of online lending business models. While some companies may possess attributes from more than one of these business models, it is important to examine how online lenders asses risk, mitigate their own exposure, and obtain capital to lend to small businesses.

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[20] Ty Kiisel, *Understanding Common Small Business Loan Terms*, ONDECK (2019) https://www.ondeck.com/resources/understanding-common-small-business-loan-terms, [hereinafter Understanding Small Business Loan Terms].

[21] Understanding Small Business Loan Terms, *supra* note 20.

[22] Understanding Small Business Loan Terms, *supra* note 20.

[23] *Examining Opportunities and Challenges in the Financial Technology ("Fintech") Marketplace: Hearing Before the Subcomm. On Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Servs.*, 115th Cong 7 (2018) (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center) [hereinafter Levitin Testimony].

[24] Levitin Testimony, *supra* note 23.

[25] Levitin Testimony, *supra* note 23.

[26] Levitin Testimony, *supra* note 23.

[27] Fed Small Business Survey 2020, *supra* note 9.

[28] Fed Small Business Survey 2020, *supra* note 9.

Peer-to-Peer (P2P) Lending

P2P lending platforms are a popular method of small business financing that combines facets of both crowdfunding and marketplace lending to pool capital from investors through internet marketplaces.[29] In P2P lending, individuals fund either a portion of or the total amount of debt and receive their principal plus interest when the borrower repays the loan.[30] P2P lending platforms, which generally act as online intermediaries, connect individual investors with small business owners seeking to borrow money and charge a fee for this connection service.[31] P2P lending platforms evaluate the borrower's risk, establish their credit rating, and assigns them an interest rate. Investors then review the loans listed on the P2P lending platform's website and compete for those in which they wish to lend, with higher risk associated with higher interest rates.[32]

Balance Sheet Lenders

While P2P lenders act as an intermediary for investors to fund small business loans, balance sheet lenders hold most or all of the loans on their own balance sheets, earn the interest on the loans, and face the credit risk if a borrower does not repay.[33] These online lenders typically use their own capital to lend to small businesses, and these loans are either originated directly on the lender's website, or through referrals or brokers.[34] Like other online lending platforms, balance sheet lenders typically loan smaller amounts and have relatively short repayment periods.

Merchant Cash Advance (MCA)

Technology has also provided new methods for small businesses to repay loan balances. For example, with MCAs for small businesses, lenders receive a fixed percentage of future credit card sales until the loan is payed off.[35] Therefore, the higher the volume of credit card transactions, the more the loan is payed off. However, there are some well-reported risks associated with the merchant cash advance option, namely extremely high APRs and high daily payments, creating the potential for a small business to enter an unsustainable cycle of debt. Furthermore, some predatory MCA companies have abused an obscure (and oftentimes confusing) legal instrument called a "confession of judgment,"[36] which if enforced by a court, can lock a small business into that unsustainable debt cycle, and ultimately forcing the shutdown of that small business. The

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[29] U.S. Small Bus. Admin., Off. of Advocacy, *Peer-to-Peer Lending: A Financing Alternative for Small Businesses* (Sep. 2015) Issue Brief 10, https://cdn.advocacy.sba.gov/wp-content/uploads/2015/06/07135609/Issue-Brief-10-P2P-Lending_0.pdf [hereinafter SBA Advocacy Issue Brief].

[30] SBA Advocacy Issue Brief, *supra* note 29.

[31] SBA Advocacy Issue Brief, *supra* note 29.

[32] Peter Renton, *Understanding Peer to Peer Lending*, LEND ACADEMY (2015) http://www.lendacademy.com/Understanding-Peer-to-Peer-Lending.pdf.

[33] CRS R44614, *supra* note 15.

[34] Federal Reserve Governor Lael Brainard, *Address at the Third Annual Community Banking and Policy Conference* (Sep. 30, 2015), https://www.federalreserve.gov/newsevents/speech/brainard20150930a.htm.

[35] Can Capital, *Merchant Cash Advance*, https://www.cancapital.com/glossary-item/merchant-cash-advance.

[36] Zachary R. Mider & Zeke Faux, *Sign Here to Lose Everything - Part 1: "I Hereby Confess Judgment"*, BLOOMBERG (2018) https://www.bloomberg.com/graphics/2018-confessions-of-judgment.

Committee held a hearing on confessions of judgment on June 26, 2019,[37] where Members explored the legal and policy issues regarding the regulation of confessions of judgment.

Current Issue – Transparency

In light of these rapidly evolving technological advances, some observers have raised concerns regarding the potential adverse outcomes of using this kind of information in underwriting small business loans. One very pointed concern is that credit determinations made by online lenders in the foregoing fashion could disparately impact minorities and other protected groups.[38] Specifically, the algorithms and data used in automated underwriting could make credit assessments that are correlated to borrower characteristics that are protected by fair-lending laws, such as race or gender.[39] Whether this correlation is intentional or not, it could result in borrowers from a protected group being disproportionately denied credit or charged higher interested rates compared with other groups.[40] As one observer stated:[41]

> While many FinTech firms claim these algorithms protect against discrimination, they have generally provided little evidence into how they are utilized to do so. These questions surrounding the algorithms are particularly troubling because, in some cases, they have the ability to utilize certain information about loan-seekers without their knowledge. Information collected can come from a wide range of sources, including the loan-seekers' Twitter or Facebook profiles, specifically who they follow, and the number of criminal records and/or bankruptcies in the loan seeker's zip code. Not only is this information unrelated to the purposes of loan seeking, it can be used to discriminate against certain people, predominantly lower-income borrowers and people of color.

As this space continues to evolve, it will be important for all online lenders to adopt disclosure and transparency policies similar to that of traditional banks (and which some online lenders have already adopted), so that borrowers can have clear and accurate information about their financing options to help them make a well-informed decision. To the extent some unfair and abusive practices persist in this space, or there are opportunities to improve the information available to small business borrowers about their financing options, further regulation and legislation[42] may be advisable to enhance transparency and ultimately, protect small businesses.

The federal Truth In Lending Act[43] ("TILA") requires transparent disclosures in consumer finance, but does not apply to small businesses. Transparent price disclosure is the foundation of free markets, without which price competition effectively fails. Today, small businesses with suboptimal information often overpay for credit, hurting their ability to recover from the pandemic,

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[37] *Crushed by Confessions of Judgment: The Small Business Story: Hearing Before the H. Comm. on Small Bus.*, 116th Cong. (2019), Hearing Memorandum available at: https://smallbusiness.house.gov/uploadedfiles/06-26-19_hearing_memo.pdf.

[38] CRS R44614, *supra* note 15.

[39] CRS R44614, *supra* note 15.

[40] CRS R44614, *supra* note 15.

[41] Cleaver Report, *supra* note 1.

[42] *See, e.g.*, Small Business Lending Fairness Act, H.R. 3490, 116th Cong (2019) (introduced by Congresswoman Nydia M. Velázquez); Small Business Lending Disclosure and Broker Regulation Act of 2020, H.R. 7889, 116th Cong. (2020) (introduced by Congresswoman Nydia M. Velázquez).

[43] Pub. L. 90-321.

grow their business, and hire more employees. It has therefore become necessary to pass a TILA for small businesses to enable small business owners to make fully informed decisions about their financing options. On July 30, 2020, Chairwoman Nydia M. Velázquez introduced the Small Business Lending Disclosure and Broker Regulation Act of 2020 (H.R. 7889), which would apply the Truth In Lending Act to small business loans, and enhance the role of the Consumer Financial Protection Bureau in policing the small business credit market.

Conclusion

Overall, the Fintech space presents some advantages for small businesses who choose to seek financing online. However, as many have observed, these advantages also come with risks, especially for traditionally underserved entrepreneurship communities. Through deliberate action and careful policymaking, the future of Fintech can be one where small firms can safely, quickly, and affordably access capital.