

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2561 Rayburn House Office Building
Washington, DC 20515-6515

MEMORANDUM

To: Members, Subcommittee on Oversight, Investigations, and Regulations
From: Dean Phillips, Chairman
Date: July 13, 2022
Re: Subcommittee Hybrid Hearing: “Fintech and Transparency in Small Business Lending”

The Committee on Small Business Subcommittee on Oversight, Investigations, and Regulations will meet for a hybrid hearing titled “Fintech and Transparency in Small Business Lending.” The hearing is scheduled to begin at **10:00 A.M. on Wednesday, July 13, 2022 in person in Room 2360 of the Rayburn House Office Building, and virtually via the Zoom platform.** The hearing will allow Members to examine the effect of innovations in financial technology (“Fintech”) and online lending on small businesses. Members will hear from lenders, industry advocates, and academics regarding the policy issues Congress faces in assuring a fair but efficient small business credit market among non-bank, online lenders.

Panel

- Mr. Sean Salas, Chief Executive Officer, Camino Financial, Los Angeles, CA
- Ms. Joyce Klein, Senior Director, Business Ownership Initiative, Aspen Institute, Washington, DC
- Ms. Diane Paterson, Regional Director, Twin Cities Small Business Development Center, Minneapolis, MN
- Dr. John Griffin, James A. Elkins Centennial Chair in Finance, McCombs School of Business, The University of Texas, Austin, TX

Background

“Fintech” is a broad term that describes the technology and innovation that is transforming the traditional methods of banking. Small businesses interact with fintech in various ways, including accessing capital, processing payments, and mobile banking. Research has shown that fintech lenders may be better able than traditional banks to make small-dollar loans to small businesses, as was the case during the Small Business Administration’s (SBA) Paycheck Protection Program (PPP).¹ However, the gains from fintech advances must be weighed carefully against the risks associated with these technologies, especially for underserved entrepreneurs accessing capital

¹ See, e.g., *An Empirical Review of the Paycheck Protection Program: Hearing before the H. Comm. on Small Business*, 117th Cong. (2022) (statement of Robert W. Fairlie, Professor of Economics, University of California, Santa Cruz) [hereinafter Fairlie Testimony].

from non-banks. For example, different ways of disclosing information related to the cost of capital makes it nearly impossible for the smallest businesses to compare products.² This is important because online loans often have costs that far exceed those of traditional banks. Furthermore, some online products (notably merchant cash advances, or “MCAs”) combine extremely high daily repayments with confessions of judgment, which can lock borrowers into an unsustainable cycle of debt and ultimately force the shutdown of the business.

Moreover, some fair lending advocates argue that due to a lack of transparency in the loan underwriting process used by these lenders, it is difficult to assess whether fintech underwriting methods have a discriminatory impact (whether intentional or not) on communities of color.³ Unfortunately, and even prior to the pandemic, small businesses were vulnerable to irresponsible and predatory lending practices, as well as confusing and inconsistent cost disclosures that left borrowers unable to make informed comparisons about the price of financing.⁴ This has significant consequences for borrowers, as additional research has found that many online small business loans are unaffordable, with average monthly payments almost double borrowers’ net income.⁵

Overview of the Online Small Business Lending Marketplace

Small businesses make up a significant portion of the United States economy, with 32.5 million small businesses making up 99.9 percent of all firms and employing 46.8 percent of all private sector employees.⁶ Between March 2019 and March 2020, U.S. businesses experienced a net increase of 406,001 jobs, while small businesses created 466,607 net new jobs.⁷ Furthermore, research shows that even prior to the COVID-19 pandemic, online lending was becoming an increasingly popular method for small businesses to access capital. One study found that by 2016, non-bank lenders had a market share of close to 60 percent in small business lending.⁸

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

² See, e.g., Board of Governors of the Federal Reserve System, *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*, (Dec. 2019), <https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf> [hereinafter *Uncertain Terms*]; see also, 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> [hereinafter *Browsing to Borrow*].

³ 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*].

⁴ *Browsing to Borrow*, *supra* note 2.

⁵ Opportunity Fund, *Unaffordable and Unsustainable: The New Business Lending on Main Street* (May 2016) https://aofund.org/app/uploads/2021/03/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf.

⁶ U.S. Small Bus. Admin., Off. of Advocacy, *2021 Small Business Profile – United States* (Aug. 30, 2021), <https://cdn.advocacy.sba.gov/wp-content/uploads/2021/08/30144808/2021-Small-Business-Profiles-For-The-States.pdf> [hereinafter *SBA Advocacy*].

⁷ *SBA Advocacy*, *supra* note 6.

⁸ Manasa Gopal and Philipp Schnabl, *The Rise of Finance Companies and FinTech Lenders in Small Business Lending*, (Mar. 28, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3600068.

even social media data to further understand the creditworthiness of a small business.⁹ With so much data readily available to assess creditworthiness, approvals for online loans can be almost instantaneous. Although a bank loan can take up to 60 days for approval and funding, online lenders can send funds to small businesses in as little as 48 hours.¹⁰

However, access to affordable capital remains a significant barrier to start-up and growth for millions of small businesses. Specifically, the Fed's 2022 Small Business Credit Survey Report on Employer Firms found 59 percent of respondents had unmet financing needs, due to either a financing shortfall, debt aversion, or discouragement.¹¹ Moreover, the 2022 Fed Employer Survey also found a 5 percent net satisfaction rating for online lenders, compared to a 69 percent net satisfaction rating for small banks and a 54 percent net satisfaction rating for large banks.¹² The 2021 Fed Small Business Credit Survey of Nonemployer Firms¹³ found comparably low satisfaction with online lenders in terms of access to PPP. Nonemployer firms seeking PPP loans were most successful at small banks and least successful with online lenders, with 45 percent of nonemployers applying to online lenders receiving all PPP funding sought, compared to 63 percent who sought PPP loans from a small bank, or 52 percent who sought PPP loans from a large bank.¹⁴ The low degree of borrower satisfaction with online lending, despite the advances in technology, signals the need for increased attention to this space by policymakers.

Current Issues

Disclosures in Online Small Business Lending

Many online lenders provide little or no information upfront to prospective borrowers about the loan or product, instead focusing on the ease of applying and qualifying for funding, the speed of approval, and the range of eligible uses.¹⁵ Important information such as rates, fees, and repayment details are often absent on these websites.¹⁶ For several of these, prospective borrowers must provide personal and business information to obtain information about the lenders' products.¹⁷ Even on websites with more information disclosed, specific details about repayment, fees, and

⁹ 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.

¹⁰ Ty Kiisel, *Understanding Common Small Business Loan Terms*, ONDECK (2019)

<https://www.ondeck.com/resources/understanding-common-small-business-loan-terms>.

¹¹ Federal Reserve Bank, *2022 Small Business Credit Survey: Report on Employer Firms*,

<https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2021/2022-sbcs-employer-firms-report> [hereinafter 2022 Fed Employer Survey].

¹² 2022 Fed Employer Survey, *supra* note 11. "Net satisfaction" is the share of firms satisfied minus the share of firms dissatisfied.

¹³ Federal Reserve Bank, *2021 Small Business Credit Survey: Report on Nonemployer Firms*, (Aug. 2, 2021),

<https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2021/2021-sbcs-nonemployer-firms-report> [hereinafter 2021 Fed Nonemployer Survey]. Nonemployers are the smallest businesses, having no employees other than the owner. Nonemployer firms are distinct from employer firms in more than just the employment size of the business. Nonemployers are concentrated in different industries and are more likely to be owned by women and people of color. As of June 22, 2022, the Fed has not published its Report on Nonemployer Firms for 2022.

¹⁴ 2021 Fed Nonemployer Survey, *supra* note 13.

¹⁵ Uncertain Terms, *supra* note 2.

¹⁶ *Id.*

¹⁷ *Id.*

other items were sometimes missing or not readily displayed.¹⁸ Furthermore, an analysis conducted by Fed researchers found significant variation in the terminology used to explain products' costs, obscuring the true costs of different products and making it difficult to compare products.¹⁹ Focus groups in the Fed's analysis suggested annual percentage rate of charge (APR) would help in providing a common basis for cost comparison, improving the information for small businesses given the non-standard terminology and structure of products offered by online lenders.²⁰

Costs Associated with Online Small Business Loans and Financing Products

Though online loans can help borrowers access capital quickly, the costs often far exceed those of traditional banks and credit unions. A traditional bank loan typically has an 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 or financing products such as MCAs (discussed below) can range from 7 to over 100 percent.²² In many cases, loans and products with such high interest rates would be illegal under many state usury laws, but those laws are circumvented by predatory lenders who operate a "rent-a-bank" scheme.²³ According to the 2020 Fed Employer Survey (the most recent asking this question), small businesses are aware of the higher costs associated with online lenders, as 57 percent of respondents reported "high cost or interest rate" as a challenge with online lenders.²⁴ The higher costs and relative low satisfaction associated with online lenders highlights the need for increased transparency and oversight as online lending continues to grow.

Merchant Cash Advances (MCA) and Confessions of Judgment

Technology offers new methods for small businesses to repay loan balances. For example, with MCAs, lenders receive a fixed percentage of future credit card sales until the loan is paid off.²⁵ Therefore, the higher the volume of credit card sales, the more the loan is paid off. However, there are some well-reported risks associated with MCAs, 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 use an obscure and confusing legal instrument

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Uncertain Terms, *supra* note 2.

²¹ Ty Kiisel, *Understanding Common Small Business Loan Terms*, ONDECK (2019)

<https://www.ondeck.com/resources/understanding-common-small-business-loan-terms>.

²² Uncertain Terms, *supra* note 2.

²³ See, *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). Under "rent-a-bank" schemes, loans are originated by a bank per guidelines set by the online lender and are then sold almost immediately to the online lender. Loan disbursement is generally by the bank, and loan payments may be made to the bank, but the bank is not the true economic party in interest nor is it exercising meaningful control over the design of the loan product. The intent of "rent-a-bank" transactions is for the non-bank lender to avoid the application of state usury laws by sheltering in federal law's preemption for banks of usury laws and other consumer protection laws.

²⁴ Federal Reserve Bank, *2020 Small Business Credit Survey: Report on Employer Firms*, (Apr. 7, 2020) <https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2020/2020-sbcs-employer-firms-report>.

²⁵ Can Capital, *Merchant Cash Advance*, <https://www.cancapital.com/glossary-item/merchant-cash-advance>.

called a “confession of judgment,”²⁶ which if enforced by a court, locks a small business into that unsustainable debt cycle, and ultimately forces the shutdown of that small business. The Committee held a hearing on confessions of judgment on June 26, 2019,²⁷ where Members explored the legal and policy issues regarding abusive uses of confessions of judgment.

Transparency in Underwriting

In light of rapidly evolving technological advances, some advocates have raised concerns regarding the potential adverse outcomes of using the kind of information collected by fintechs in underwriting small business loans. One concern is that credit determinations made by online lenders could disparately impact minorities and other protected groups.²⁸ Specifically, the algorithms and data used in automated underwriting could make credit assessments correlated to borrower characteristics protected by fair-lending laws, such as race or gender.²⁹ Whether intentional or not, it could result in borrowers from a protected group being unfairly denied credit or charged higher rates compared with other groups.³⁰ As one fair lending advocate stated:³¹

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, online lenders should adopt disclosure and transparency policies similar to that of traditional banks (and which some online lenders have already adopted) so that borrowers have clear information about their financing options. To the extent unfair and abusive lending practices persist, further regulation and legislation may be needed to improve transparency, enhance oversight over non-banks, and ultimately, protect small businesses.

Fintech Lenders in SBA’s Paycheck Protection Program

The PPP was established in the CARES Act³² as a subprogram of SBA’s 7(a) loan guarantee program. Under PPP, banks and other private lenders make fully guaranteed SBA loans to small businesses negatively impacted by the COVID-19 pandemic. The loans are intended to assist small businesses with meeting payroll costs and other expenses, and full loan forgiveness is offered if

²⁶ 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>.

²⁷ *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.

²⁸ Cong. Research Serv., *Marketplace Lending Fintech in Consumer and Small-Business Lending*, R44614 (Sep. 4, 2018) [hereinafter CRS Fintech Report].

²⁹ CRS Fintech Report, *supra* note 28.

³⁰ *Id.*

³¹ Cleaver Report, *supra* note 3.

³² P.L. 116-136.

loan proceeds are spent on such purposes. In total, over \$800 billion has been appropriated for PPP in several pieces of legislation. Furthermore, the PPP and Health Care Enhancement Act³³ (Enhancement Act) included set-asides of newly appropriated PPP funds so that community lending institutions, including Community Development Financial Institutions (CDFIs), Certified Development Companies (CDCs) and SBA Microloan Intermediaries could participate in the program fairly alongside large banks. These set-asides were intended to maximize PPP lending in traditionally underserved business communities.

On April 12, 2020, SBA released the nonbank lender application form allowing new nonbank lenders to participate in PPP.³⁴ On April 30, 2020, SBA published an Interim Final Rule adjusting portfolio requirements for CDFIs, MDIs, and other nonbank lenders, which allowed smaller lenders to participate in PPP.³⁵ These nonbank lenders included SBA Small Business Lending Companies (SBLCs) and Non-Federally Regulated Lenders (NFRLs). As stated above, PPP research has shown nonbanks, CDFIs, and MDIs made a higher proportion of loans to traditionally underserved businesses than other types of lenders.³⁶

However, research also shows there is a higher degree of potential fraud associated with nonbank-originated (specifically Fintech-originated) PPP loans.³⁷ Some Fintech lenders have sought to become an SBA 7(a) lender through SBA's SBLC license, however SBA placed a moratorium on approving new SBLCs in 1982. SBA did so to reduce the administrative resources needed to prudently regulate and oversee non-depository lenders with a nationwide 7(a) lending platform. Importantly, in a final rule posted December 4, 2020 on SBLCs and NFRLs, SBA stated it "does not have the administrative resources needed to oversee NFRLs with a nationwide 7(a) lending platform in addition to the 14 SBLCs it currently regulates."³⁸ In this final rule, SBA signaled it did not intend to re-open the SBLC license for existing or prospective NFRLs interested in making 7(a) loans nationwide by saying it "encourages [these lenders] to acquire one of the fourteen SBLC licenses that become available from time to time."³⁹

Conclusion

Overall, fintech presents some advantages for small businesses who seek financing online, such as quick approval and improved access to capital for the smallest borrowers. However, these advantages also come with risks, especially for the smallest firms and underserved entrepreneurs, who can face increased costs, potential lending discrimination, and in some cases abusive lending

³³ P.L. 116-139.

³⁴ U.S. Small Bus. Admin., *CARES Act Section 1102 Lender Agreement – Non-Bank and Non-Insured Depository Institution Lenders*, SBA Form 3507 (04/21), <https://home.treasury.gov/system/files/136/SBA-Form-3507-PPP--Agreement-for-New-Lenders-Non-Bank-Non-Insured-Depository-Institution-Lenders.pdf>.

³⁵ U.S. Small Bus. Admin., *Interim Final Rule on Corporate Groups and Non-Bank and Non-Insured Depository Institution Lenders (originally posted 4/30/2020)*, (Apr. 30, 2020), <https://home.treasury.gov/system/files/136/IFR--Corporate-Groups-and-Non-Bank-and-Non-Insured-Depository-Institution-Lenders.pdf>.

³⁶ See Fairlie Testimony, *supra* note 1.

³⁷ See, Griffin, John M. and Kruger, Samuel and Mahajan, Prateek, *Did FinTech Lenders Facilitate PPP Fraud?*, (Dec. 6, 2021), <https://ssrn.com/abstract=3906395>.

³⁸ U.S. Small Bus. Admin., *SBA Supervised Lenders Application Process*, (Dec. 4, 2020) <https://downloads.regulations.gov/SBA-2020-0001-0021/content.pdf>.

³⁹ *Id.*

practices. Through deliberate action and careful policymaking, the future of fintech can be one where small firms can safely, quickly, and affordably access capital online.