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“Fintech and Transparency in Small Business Lending”

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Chairman Phillips, Ranking Member Van Duynes and members of the of the Committee, thank you for inviting me to appear before the Oversight, Investigations, and Regulations Subcommittee today to speak with you about the importance of transparency and the role of financial technology in small business lending. My name is Joyce Klein and I am the Senior Director of the Aspen Institute’s Business Ownership Initiative. The Aspen Institute is a global nonpartisan, nonprofit organization committed to realizing a free, just, and equitable society. Founded in 1949, the Institute drives change through dialogue, leadership, and action to help solve the most important challenges facing the United States and the world. The Business Ownership Initiative is a part of the Institute’s Economic Opportunities Program, and the mission of the Initiative is to expand economic opportunity through business ownership.

At the Business Ownership Initiative, we are focused on understanding the needs of and barriers facing the most underserved small businesses and developing solutions for reaching them. Our goal is to ensure that all business owners -- regardless of race, gender, place or other factors -- have an equal shot at accessing resources to start and grow their businesses, and through those businesses to generate income and wealth for their families, their workers and their communities. We have been doing this work at the Aspen Institute for 30 years. Over that time, we have seen many changes in the financial services landscape, including consolidation among banks, the significant growth of CDFIs, and the emergence of financial technology. But one constant over this period is the fact that entrepreneurs still face challenges in accessing capital and resources to start and grow; this is particularly true for certain types of entrepreneurs, including women, people of color, immigrants and those living in rural communities. In the past seven years, our work has placed a particular focus on the needs of and barriers faced by business owners of color.

In our work, we do primary research, working with Community Development Financial Institutions to survey their borrowers and to evaluate their work. We also closely follow the research of others, including the Federal Reserve and academic researchers. We work closely with CDFIs, learning with and from them about the most effective practices in reaching underserved businesses. And we use the knowledge we build to help CDFIs to go broader and deeper in serving underserved markets, to scale their lending and to communicate what works and what they need to funders, investors and policymakers.

In addition to my role at the Aspen Institute, I also serve as the chair of the executive committee of the Responsible Business Lending Coalition. The RBLC is a network of non-profit and for-profit lenders, investors, and small business advocates that share a commitment to innovation in small business lending and serious concerns about the rise of irresponsible small business lending. The RBLC's mission is to drive responsible practice in the small business lending sector.

The Aspen Institute joined as a founding member of the RBLC in 2015 because we were concerned about the dramatic growth of predatory products and practices in the small business lending market that occurred after the Great Recession. The CDFIs we work with began to share example after example of small business owners coming to them because they were about to lose their businesses due to the impact of financing they had received. These borrowers took on debt in the form of new types of financing products, without being able to fully understand the cost of the financing and its impact on their cash flow and profitability.¹ When they went to a CDFI seeking help in refinancing, they often found that the financing contracts were not only beyond their businesses' ability to repay, they also required the borrower to pay the full (or virtually all of the) financing costs even if they paid the financing off early. So often the CDFIs could not help them.

We decided that it was essential to our mission – which again is to open access to business owners who have been excluded or underserved – to make sure that they had access to the same sorts of protections that consumers have when seeking financing. We thought it important to work not only with CDFIs, but with fintech lenders, small business advocates, and investors to help to ensure that products offered in the market are fair and responsible.

My remarks today draw both from our work at the Aspen Institute and from the work of the RBLC.

My sense is that the goal of the Small Business Committee is aligned with our goal at the Aspen Institute – which is to make sure that small business owners have access to the resources they need to start, grow, and importantly, for their businesses to thrive. Today's hearing comes at a dynamic and uncertain time for small businesses. Most small businesses were battered by the pandemic, and some continue to struggle to adjust to changing demand and labor market dynamics and supply chain challenges. At the same time, we have seen record levels of new business starts.² If we want to realize the potential of all these small firms, we need to make sure they are able to access the right capital.

"Fintech" is a term that has quickly become part of our lexicon and is often used to refer to a specific type of company – a "fintech" firm. But when considering the implications of fintech for small business lending, it is important to focus on financial technology in the broadest sense, which involves the application of digital technologies to financial transactions. Today virtually every type of small business lender – whether they are depositories like banks and credit unions, or non-depositories including CDFIs, fintech firms and other commercial lenders and finance companies -- is using financial technology to expand its reach, lower costs and or/increase efficiency. There are many ways in which financial

¹ Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," 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

² See <https://www.aspeninstitute.org/blog-posts/financing-the-small-business-recovery-7-key-facts-and-challenges-for-2022/>.

technology can be a positive force in expanding access to capital to business owners and prospective business owners who have long been excluded from or marginalized in our capital markets. In fact, many mission-oriented lenders – CDFIs – are working hard to integrate financial technology into their work, because they see its value. But what we have learned in our work is that if the goal is to expand access to responsible capital for the business owners who are the most challenged to access credit, the most important factor is not the type of institution or firm that is offering the capital or the type of technology they use. ***What is most important is ensuring that we are getting the financial products and the financing practices right.***

I will speak first to the importance of product. In our work at the Business Ownership Initiative, we have partnered with CDFIs that have intentionally and successfully worked to increase their lending to business owners of color.³ Where we have seen progress is when lenders offer smaller loans and when they are able to underwrite loans based more on cash flow and on a flexible look at credit histories, rather than by focusing on collateral, equity and credit scores. Products with these features have enabled lenders to reach business owners who may have thin credit files or less than prime credit scores, who have low wealth levels and therefore little or no capacity to provide collateral or to invest their own equity into their business, and whose businesses are smaller and can only service debt on smaller loans (less than \$100K). This is where we see the majority of businesses owned by people of color, due to the well-documented barriers they have faced to accessing credit, building wealth and other factors. These characteristics are also shared by many women, rural and other entrepreneurs.

Financial technology can play a role in helping lenders to offer these products more cost-effectively – by enabling them to quickly access information on cash flow, and by allowing them to build credit and scoring models that take into account factors other than performance on past credit. And lenders of all types are working to use these technologies. But the right products alone will not result in the outcomes we want.

Financing practices are important, for two reasons. First, practices are essential in reaching segments of the small business community that have not been reached by banks, that have been excluded from or preyed upon in financial markets, and small business owners who have limited capacity to apply for loans. These practices including outreach and marketing strategies that build trust, that match the language needs of the owners, and that allow entrepreneurs to apply at times and in ways that are convenient and using information they can easily supply.⁴ This is where CDFIs are particularly adept because of the ways they connect to communities and build trust, and where fintech lenders often bring customer-friendly technology and user experiences.

But while it is important that we find ways to reach underserved borrowers, we always need to balance greater access with borrower protections. The economics of smaller dollar business lending are challenging – it is expensive to find customers, and to make and service loans relative to the amount of

³ Eric Weaver, Joyce Klein and Tim Ogden, “Scaling Lending to Entrepreneurs of Color,” 2021. See <https://www.aspeninstitute.org/publications/scaling-lending-to-entrepreneurs-of-color-part-i-core-operational-challenges/>.

⁴ See, for example, Joyce Klein and Sarah Alvarez, “San Francisco Entrepreneurs of Color Fund: Creating a Continuum of Capital and Consulting,” October 2020. <https://www.aspeninstitute.org/publications/san-francisco-entrepreneurs-of-color-fund-creating-a-continuum-of-capital-and-consulting/>

interest one generates on a small often unsecured loan. We see this with small dollar financial transactions in consumer lending markets, and we see this in small business lending markets as well. One of the challenges is business lending is that there are few borrower protections, because the Truth-in-Lending Act does not apply to most commercial financing.

This brings me back to our work with the Responsible Business Lending Coalition. As I noted previously, the RBLC was created in response to the increase in unsustainable and unaffordable financing that emerged in large scale after the Great Recession. We saw a dramatic increase at that time as banks pulled back their small business lending significantly, especially at the smallest loan amounts. A variety of lenders stepped into the market to fill that gap. Some were fintech startups that emerged at that time. Some were lenders such as merchant cash advance firms that use technology but existed before the financial crisis and are not typically considered “fintech” firms. Some offered products that were responsible, but others offered products that created significant distress for the business owners. In distinguishing between whether the financing is good or bad, I would again stress that what is important was not the type of company or the type of technology it uses, but the lending products offered and the practices used.

That is why we worked with a coalition of lenders (both fintech lenders and CDFIs), small business advocates and investors to create the Small Business Borrowers Bill of Rights.⁵ Our focus was on putting the borrower at the center of the transaction. And we identified six key rights for small business borrowers that we thought should be upheld in any transaction:

1. The Right to Transparent Pricing and Terms: A borrower has the right to have the cost and terms of any financing being offered presented to them in writing, including the APR, and in a form that is clear, complete, and easy to compare with other financing options, so they can make the best decision for their business.

2. The Right to Non-Abusive Products: A borrower has the right to expect that the financing products offered by a lender will not trap his/her business in an expensive cycle of re-borrowing.

3. The Right to Responsible Underwriting: A borrower has the right to expect a lender is offering financing based on underwriting practices that assess the ability of the borrower’s business to succeed and repay.

4. The Right to Fair Treatment from Brokers: A borrower has the right to honest, transparent, and impartial communications with a broker regarding loan options, conflicts of interest, fees, and the financing options available.

5. The Right to Inclusive Credit Access: A borrower has the right to fair and equal treatment when seeking a loan including protections guaranteed under the Equal Credit Opportunity Act.

6. The Right to Fair Collections Practices: A borrower has the right to be treated fairly and respectfully

⁵ See <http://www.borrowersbillofrights.org/>.

throughout a collections process and the right to protections like those guaranteed under the Fair Debt Collection Practices Act.

After we identified each of these rights, the Coalition created a set of detailed practices that lenders can and should use to uphold these rights, and we asked lenders and brokers to join us as signatories, and others who were not lenders to join as endorsers.⁶ Again, these practices are agnostic as to the type of technology used or the type of lending institution involved.

We have also worked to codify some parts of the BBoR into policy, with a focus on transparency. We are pleased to have been part of large and diverse coalitions that have been successful in passing small business truth-in-lending legislation in California and New York and have been working to implement these new state laws. California recently issued final guidance on its disclosure law. And the RBLC is grateful for the work that Chairwoman Nydia Velazquez has done promote transparency in small business financing, including her leadership in introducing H.R. 6054, the Small Business Lending Disclosure Act of 2021, a bill that would require lenders to disclose information that enables small businesses to make informed choices. Better information is critical to enabling businesses to succeed over the long term, and in driving price competition.

We believe it is vital that small businesses who are seeking financing have the information to fully understand the cost and terms of each offer, and to easily compare across products, so that they can make the best choice for their business and their financial circumstances. Central to the ability to easily compare is disclosure of the annual percentage rate (APR), which is the only metric that allows borrowers to compare cost across various pricing approaches and terms.

The original rationale for not extending truth-in-lending or disclosure protections to commercial loan transactions was based on the belief that businesses had much greater financial expertise at their disposal – they had comptrollers or chief financial officers on staff, or CPAs who could provide financial advice when they sought financing. This is certainly true for some businesses, but not for most. A majority of small businesses in the U.S. are sole proprietors, not corporations. They operate home day care centers; cleaning and landscaping businesses; food trucks, catering firms and cafes; small retail shops; hair and nail salons. They do their finances using QuickBooks, often in the evenings or around their core working hours. They may or may not have a part-time bookkeeper or accountant to help them set up their books, or an accountant or tax prep firm that helps them file taxes.

APR is the only metric that enables apples-to-apples comparisons among products with different fees, interest, and term lengths over a common unit of time. As has been documented by research conducted by the Federal Reserve, small business owners applying for financing online may be receive offers that quote prices in very different ways. For example, they may be offered a five-year term loan with a 15% interest rate and \$1,000 origination fee, a 12-month cash advance with a 4% fee rate (not an interest rate), and a credit card with a 24.9% APR.⁷ For the typical small business owner, it is very difficult to analyze and compare the relative costs of these products, and to determine their potential effect on

⁶ See http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/bbor_2021_-_clean_copy.pdf.

⁷ Barbara Lipman and Ann Marie Wiersch, “Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites,” 2019. <https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf>.

their cash flow. As a result, small businesses today are often overpaying for financing, sometimes with devastating results for the business.

This lack of transparency is also inhibiting competition and innovation in the financing markets. Market competition relies on price disclosure. Today, without transparent disclosure and the ability to compare costs, financing companies do not have a strong incentive to lower the prices they charge small business. Instead, lenders often compete on the speed or ease of accessing the financing. There is a lesser reward for lowering prices, and so innovation to lower prices may not be rewarded. As a result, small business financing prices remain high. This reduces the ability of business owners to reinvest in the growth and health of their businesses, support their workers, or use the profits of their business to support and invest in their families and communities.

H.R. 6054 would require lenders to disclose information that enables small businesses to make informed choices. Better information is critical to enabling businesses to succeed over the long term, and in driving pricing competition.

Addressing transparency and disclosure in small business financing is increasingly important now because higher-cost, short-term financing is becoming a common and sometimes dominant product in the market. For example, in 2018 lenders that offered what Federal Reserve researchers described as “potentially higher cost and less transparent credit products”⁸ originated more than \$10B in financing to small businesses.⁹ This compares to a total of \$25.8 B in originations under the 7(a) program.¹⁰ The growth in higher cost and less transparent products may be occurring in part because are the only type of financing offered to small business when they are using their payments processing system or other small business tool. Again, I would stress here that the issue is not that technology is enabling new types of products to be created, for example, through payment processing or other small business tools. In fact, there can be significant advantages to small businesses because of these technological innovations. The concern is when the products offered and practices used in delivering them are not transparent and fair.

I would like to close by speaking to the experience with the Paycheck Protection Program. Our team at the Business Ownership Initiative was concerned (although not surprised) with the outcomes during the initial rounds of the program, when PPP loans were largely originated by banks. We saw the program bypassing the smallest firms and those without an existing lending relationship with a bank. As the program was expanded to include more CDFIs and fintech firms, and as it was also changed to better cover the costs incurred for making small loans (by providing a minimum fee rather than a fee based on a percentage of the loan amount), we saw the level of lending to smaller firms, to people of color and women, increase significantly. Again, this is in part because it made sense for lenders to make smaller loans. It was also because the program to include lenders that had established practices for reaching and

⁸ Federal Reserve Bank of Atlanta, *Small Business Credit Survey Report on Minority-Owned Firms*, December 2019, p. IV. <https://www.fedsmallbusiness.org/survey/2019/report-on-minority-owned-firms>

⁹ See <https://debanked.com/2019/05/amazon-now-among-the-top-online-small-business-lenders-in-the-united-states/>.

¹⁰ Windsor Advantage, “2018 SBA 7(a) Loan Market Outlook: Top SBA Lenders Focus on Technology as Key Differentiator,” <https://www.windsoradvantage.com/wp-content/uploads/2018/03/WindsorAdvantage-2018SBALoanMarketOutlook-WhitePaper.pdf>.

building trust with individuals and communities that have typically not been served by banks. Financial technology also played a role – partly because fintech lenders with stronger digital capacities entered the program, and because more traditional lenders and CDFIs brought in and created partnerships with fintech firms – some of which were lenders; others of which offered digital tools that could speed up the origination process.

But as we think about the lessons of PPP for the SBA’s work going forward, and for increasing access to capital more broadly, it is important to recognize that the PPP was a product that posed little to no risk to the small business – because it was forgivable, and if not forgiven, the terms of the loan were very favorable (1% interest, five-year term, no fees or prepayment penalties). As we move back into a more typical lending environment, when both the lenders and the borrowers are taking on risk and there is a wide range of potential products on offer, we need to make sure that the products and practices being offered are those that benefit the borrowers over time. We should also recognize that as we transition to a more typical lending environment and set of products, we will not see the scale and level of speed experienced during the PPP – because demand will be lower as the cost and risk rise, and because the underwriting process will be more complex.

I would also like to highlight the important role that CDFIs played in providing financial assistance to small businesses during the pandemic, and particularly in reaching the smallest and most excluded firms. This is not just about their engagement in PPP, although that was quite strong; CDFIs also provided relief in addition to the PPP. For example, we work with six of the nation’s largest CDFI lenders as part of our Microfinance Impact Collaborative.¹¹ Since the beginning of the pandemic, collectively these CDFIs originated more than 35,000 PPP loans totaling more than \$424 million. That is an average PPP loan size of less than \$12,000, so clearly these were loans to very small firms. In addition to their PPP lending, however, these six CDFIs also originated more than 5,600 loans totaling \$167 million through other state and local relief loan programs. And they distributed close to 33,000 grants totaling more than \$600 million, again to small businesses. They also provided management advice and support to many thousands of businesses on strategies they could use to weather and adapt during the pandemic.

Some of the non-PPP funds distributed by these CDFIs went to small businesses that also received a PPP loan. This was important in the case of businesses whose payroll costs represented a relatively low percentage of their total expenses; additional relief funds could help them to continue to operate and meet their financial obligations. In other instances, relief funding went to small firms that were unable to access the PPP because they lacked the needed paperwork. I share this experience to reinforce the important role that CDFIs can and should play as a critical delivery mechanism for reaching the smallest and most underserved businesses.

Thank you, Chair Phillips and members of the Subcommittee, for raising these important issues for the opportunity to testify today. I will be happy to any questions you may have.

¹¹ The six CDFIs participating in BOI’s [Microfinance Impact Collaborative](#) are [Accion Opportunity Fund](#), [Allies for Community Business](#), [Ascendus](#), [Dreamspring](#), [Justine PETERSEN](#), and [LiftFund](#).