

FINANCING THROUGH FINTECH: ONLINE
LENDING'S ROLE IN IMPROVING SMALL
BUSINESS CAPITAL ACCESS

HEARING
BEFORE THE
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX, AND CAPITAL ACCESS
OF THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES
ONE HUNDRED FIFTEENTH CONGRESS
FIRST SESSION
HEARING HELD
OCTOBER 26, 2017



Small Business Committee Document Number 115-044
Available via the GPO Website: www.fdsys.gov

U.S. GOVERNMENT PUBLISHING OFFICE

27-255

WASHINGTON : 2018

For sale by the Superintendent of Documents, U.S. Government Publishing Office
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FINANCING THROUGH FINTECH: ONLINE LENDING'S ROLE IN IMPROVING SMALL- BUSINESS CAPITAL ACCESS

THURSDAY, OCTOBER 26, 2017

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX, AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:04 a.m., in Room 2360, Rayburn House Office Building, Hon. Dave Brat [chairman of the Subcommittee] presiding.

Present: Representatives Brat, Luetkemeyer, Evans, and Clarke.

Chairman BRAT. Good morning. I would like to call this hearing to order.

And I think we will get underway. I don't know if you are all familiar with this place, but we have votes this morning at about 10:30. So we will just go, and we may have to let out for a few minutes and reconvene after votes. We are not expecting a huge vote series, but it will probably be 20 or 30 minutes, just so you all know what is heading our way.

Let's just start off and dig in. I will try to get through some of this rapidly.

Small-business access to capital has always been a top priority for this Committee. Access to capital gives small businesses the resources they need to keep the lights on, purchase inventory, pay their employees, and expand their business. For decades, small-business owners typically went to their local community bank to receive this capital. These banks were the backbone of how Main Streets across this Nation were created.

However, the amount of community banks in the United States has fallen dramatically in recent years, and regulations such as Dodd-Frank have made it more difficult for small businesses to acquire loans through traditional means. Therefore, many small businesses have had to resort to other means to acquire capital.

One private-sector solution that has grown considerably in recent years to address this credit gap is online lending. While it is difficult to estimate the size of this industry, online lenders originated an estimated \$5 billion to \$7 billion in loans to small businesses in 2015, and it is expected to become a \$50 billion industry by 2020.

While this is an emerging industry with several types of business models to assess risk, mitigate lender exposure, and obtain the cap-

ital to lend to small businesses, online lenders typically offer smaller loans with rapid approval and funding times.

This morning, we will hear from a distinguished panel of witnesses who will give their perspective on recent trends in the small-business online lending industry and how it fits into the overall small-business credit market. I appreciate the witnesses' being here today.

Thank you all very much for coming. I look forward to your testimony.

I now yield to the ranking member for his opening remarks.

Mr. EVANS. Thank you, Mr. Chairman.

Access to capital is critical to the success of small business. However, obtaining conventional credit can be particularly difficult for many small firms. Lending requirements are much tighter now than they were before the financial crisis, and small businesses, especially startups, are still considered a risky bet by many lenders.

Although FinTech provides significant advantages, there are some drawbacks. FinTech lending platforms reserve the right to reject small-business applications, just like traditional banks. In 2014, the Federal Reserve found only 8 percent of business loan applications are accepted by the larger platform. Today's hearing will provide members with an opportunity to learn about the online lending market and how it has helped increase access to capital for small businesses.

Today, many firms are turning to alternative lending that operates on an online lending platform. These services have made hundreds of millions of dollars available to small firms by offering a number of benefits over traditional sources but do have some drawbacks. I look forward to hearing from our witnesses on ways to improve the marketplace and increase access to capital for the nation's job creators and innovators.

Thank you, Mr. Chairman. I yield back.

Chairman BRAT. Thanks.

If Committee members have an opening statement prepared, I ask they be submitted for the record.

I would like to take a moment to explain the timing lights for our panel today. You will each have 5 minutes to deliver your testimony. The light will start out green. When you have 1 minute remaining, the light will turn to yellow. And, finally, at the end of your 5 minutes, it will turn red. I ask that you try to adhere to that time limit as best you can.

And, with that, we will get off to our testimony.

Our first witness today is Mr. William Phelan, the president and co-founder of PayNet, Incorporated, in Skokie, Illinois. PayNet provides small-business credit data analysis to a variety of clients. He also serves on the Advisory Council on Agriculture, Small Business, and Labor to the Federal Reserve Board of Chicago.

Thank you for being here this morning. You are recognized for 5 minutes. Thank you.

STATEMENTS OF WILLIAM PHELAN, PRESIDENT AND CO-FOUNDER, PAYNET, INC., SKOKIE, ILLINOIS; KATHERINE FISHER, PARTNER, HUDSON COOK, HANOVER, MARYLAND; AND TREVOR DRYER, CHIEF EXECUTIVE OFFICER, MIRADOR, PORTLAND, OREGON

STATEMENT OF WILLIAM PHELAN

Mr. PHELAN. Thank you, Mr. Chairman. Thank you for that introduction.

The financial crisis, as you all state, disrupted the credit markets. Traditional banks, as you also mentioned, and even large banks were preoccupied and didn't find lending to be as profitable. FinTechs jumped in, as you said, Chairman, to fill the credit gap, but they have their own challenges as well.

Let me just briefly talk about the credit conditions for small businesses right now. There is less investment being taken by small businesses right now. From the period 2015 to 2017, small-business investment is actually down 1 percent, versus 2005 to 2007 where it was up 12 percent. Having said that, the financial health of small businesses is extremely strong right now. Their days-past-due are actually better than they were before the recession.

Very briefly, let me just mention the size of this market. It is important to understand the sheer scope of the small-business credit market. We estimate over \$1 trillion in total credit. Banks make up the biggest portion of that, about \$700 billion; commercial finance, about \$250 billion. And alternative finance, or FinTech, is about \$5 billion to \$7 billion right now.

Briefly, you mentioned the banks and the challenges they have had. They undergo a credit process. The credit process consists of 28 different steps. It can cost a bank \$5,000 to \$7,000 to complete one credit application, so it is a very expensive process for a bank. And then they have to spend a lot of time actually reviewing those loans, and that is another \$1,000 of cost per review.

You mentioned the credit gap, as well, in your opening. I would like to point out that Harvard Business School conducted a research study called "The Decline of Big Bank Lending to Small Businesses: Dynamic Impacts on Local Credit and Labor Markets." This was authored by Jeremy Stein, an ex-Fed Governor, and two of his colleagues.

What they found was that fewer businesses expanded employment as the large big-four banks pulled back on providing capital. Unemployment rates rose; wages fell. The effects were concentrated in industries like manufacturing. As a result, small banks, nonbank finance companies, and FinTechs jumped in to fill that gap. And so there is evidence of this shown in this Harvard study.

Wages are lower and that still persists, which means there is more work to be done.

You mentioned in your memo the size of FinTech, at \$5 billion to \$7 billion, so I won't dwell on that. They do make traditional loans. They make working capital loans. There are several coalitions that have banded together to make disclosure available, such as the Innovative Lending Platform Association, the Responsible Business Lending Coalition, and the Electronic Transaction Asso-

ciation. And they have all instituted disclosures to help understand the cost of this capital.

Very briefly, I want to point out the credit quality of the type of businesses that uses FinTech. We have seen their credit quality improved from 2009 through 2016. The credit scores were about 660 back in 2009; they were almost 670 in 2016. We have seen the FinTechs actually increase the balance of the loans that they are providing small businesses. They were in the \$20,000 size; now they are at the \$65,000 size. We have also seen them expand the length of the loans that they are providing. These were previously very short-term loans, 6-month-type loans. Now they are averaging of 15 months.

We have seen that the businesses that they lend to are actually longer-established businesses. This was really interesting in some of the research, that showed they are lending to businesses that have been in business for 10 or more years to the tune of about 70 percent of their borrowings going to those kinds of businesses, versus 77 percent for banks. And they are expanding into diverse industries. We are seeing lending into retail, health care, accommodation & food, construction, professional services, wholesale trade, transportation, administration, and manufacturing.

Very briefly, we at PayNet conducted a study that looked at what happens to businesses that borrow from online, or FinTech, lenders. And we see that about 80 percent of them have actually climbed the credit ladder and have seen their credit and their financial health improve over that timeframe. So that was an important finding from the study.

But we also note that there is a long way to go for FinTechs to be successful. They have done a good job developing the technology, but they still have work to do on acquiring accounts, and obtaining access to capital. And they are on the road towards making this disclosure, which I think is an important part of what they have to do to further bolster their business models.

With that, I will wrap up my comments. Thank you.

Chairman BRAT. All right. Thank you, Mr. Phelan. We appreciate your testimony. That was very good.

Next is Katherine Fisher, partner with Hudson Cook, LLP, in the Hanover, Maryland, office, where she is primarily focused on the areas of consumer financial services and small-business financing.

Thank you very much for being here this morning, and you may begin your comments. Thank you.

STATEMENT OF KATHERINE FISHER

Ms. FISHER. Thank you. Chairman Brat, Ranking Member Evans, and Committee members, thank you for the opportunity to present testimony today regarding financing through FinTech, on-line lending's role in improving small-business capital access.

I am here today on behalf of the Commercial Finance Coalition, a group of responsible finance companies that provide needed capital to small- and medium-size businesses through innovative methods.

Small businesses face a gap credit in credit availability. Commercial Finance Coalition member companies are trying to close this

gap and help spur entrepreneurship so more Americans can own and operate their own businesses.

In my testimony today, I will provide an overview of the types of financing available to small businesses, with an emphasis on some of the more innovative financing options. I also will address existing regulation on small business, which is sufficient to protect small businesses.

First, small businesses need choices. Small businesses benefit from having different types of financing available. A business owner who is planning for longer-term capital needs may choose to apply for a loan guaranteed by the Small Business Administration. These SBA loans are relatively low-cost. They range typically from \$25,000 to \$5 million. To apply for an SBA loan, the loan applicant must submit a business plan, and the business owner must often use her house as collateral for the loan.

In contrast, a business owner who has short-term capital needs may choose to apply for a loan from a nonbank lender or to sell future receivables to a merchant cash-advance company. These types of transactions are typically higher-cost than traditional SBA loans and are in smaller dollar amounts. To apply for one of these loans, or MCAs, the applicant usually must submit bank statements showing several months' worth of revenue, and the business can receive funds in a matter of days.

MCA companies—these are merchant cash-advance companies—are primarily balance sheet funders who have an interest in the success of the business. MCAs are also unique because they allow the merchant to adjust the terms of the transaction to match their revenue.

Whatever the type of financing a business owner chooses, banks alone are not addressing the needs of small business. Other financing sources are finding success because small businesses demand them. This demand shows that small businesses are being underserved by the traditional funding sources.

The MCA and commercial lending spaces are sufficiently regulated by existing Federal and State laws and regulations. Both MCA companies and commercial lenders must comply with laws and regulations affecting nearly every aspect of their transactions, from marketing and underwriting through servicing and collections.

Even when they comply with every applicable law and regulation, small-business lenders must also be wary of the Federal Trade Commission's powerful authority to prevent unfair or deceptive acts or practices. Commercial lenders must comply with additional Federal regulation, and many States subject them to comprehensive licensing and regulatory schemes.

For example, on the Federal level, commercial lenders must comply with the Equal Credit Opportunity Act and its implementing Regulation B, which prohibits discrimination against protected classes of people in the extension of credit. The Equal Credit Opportunity Act and Reg B apply to business credit and provide protection specifically for business borrowers.

Another example is the Fair Credit Reporting Act, which requires a funder to have a permissible purpose to pull a consumer report for a sole proprietor or for an individual guarantor of a busi-

ness transaction. This is particularly relevant in the world of small-business finance, where the business is often organized as a sole proprietor or the individual owner will serve as a guarantor in the event that the business defaults.

Finally, many States require a license to make a loan to a business, limit the interest rates lenders may charge to business borrowers, or both. And with State licensing programs comes regulatory oversight. States that regulate lending also typically limit the terms of loans, require disclosures and loan documents, and limit the fees that creditors may impose. Most State laws regulating lending apply to loans with smaller dollar values, and these are exactly the types of loans upon which small businesses rely.

I am very optimistic that FinTech and alternative finance will fill the void for those underserved by traditional banks and financial institutions, providing much-needed access to capital for small businesses.

Thank you.

Chairman BRAT. Thank you, Ms. Fisher. We appreciate your testimony as well. Thank you very much.

And I will now yield to our ranking member for the introduction of the final witness.

Mr. EVANS. Thank you, Mr. Chairman.

Our last witness is Mr. Dryer, CEO of—the company is Mirador? Did I get that right?

Mr. DRYER. Mirador.

Mr. EVANS.—Mirador Finance in Portland, Oregon.

Mr. Dryer received his B.A. in history and literature from Harvard University before receiving his J.D. from Stanford University Law School.

Thank you for being here this morning, and you may begin. Thank you, Mr. Dryer.

STATEMENT OF TREVOR DRYER

Mr. DRYER. All right. Chairman Brat and Ranking Member Evans, thank you for the opportunity to testify today. It is really an honor to be here.

As mentioned, my name is Trevor Dryer. I am the CEO of Mirador, which is a small business headquartered in Portland, Oregon. Mirador is a white-label, third-party service provider working with regional, midsized, and community banks, credit unions, and non-profit CDFIs. Mirador is dedicated to the proposition that regulated financial services companies want to serve small businesses in their communities.

Mirador is not a lender. Our platform focuses on improving the engagement and experience between borrower and lender, supporting commercial term loans, SBA-backed loans, working capital lines of credit, commercial real estate loans, and small-dollar loans.

When a borrower goes to one of our customers' branches or to their website to apply for a business loan, they are routed onto the Mirador platform. However, they likely won't even know they have left the bank site, and we want it that way.

Borrowers can follow simple steps to fill out the application, and Mirador technology completes a credit memo by pulling additional data from public records, credit bureaus, accounting software, bank

accounts, and the IRS, which is returned to a bank's loan officer with a simple indication of credit worthiness based on the lender's credit criteria.

We are paid for every credit memo we complete without regard to the final outcome of the application.

The benefit to our bank customers is a vast reduction in the time and cost to process the loan. For the borrowers, they benefit from an equally steep reduction in the time it takes to go from the application to the funding of the loan.

As we grow our client base, we are creating a network of partners, borrowers, and lenders passing along customers to ensure that any small business can gain access to credit from a regulated institution without having to go through the time and trouble of starting the application process over each time. This is also a unique way to increase awareness of low-cost lenders, such as lead-er CDFIs, that traditionally do not engage in marketing activities.

Innovation in the area of small-business lending is improving acces to capital. However, a number of issues still negatively system impact this market and place the borrower at a disadvantage. To that end, I proffer a few recommendations to further remove pain points for small-business borrowers and lenders.

First, I strongly encourage the IRS to automate the 4506-T process for a third party to obtain a tax transcript. Congressmen McHenry and Blumenauer, as well as the ranking member of this Committee, Congresswoman Velázquez, introduced H.R. 3860, the IRS Data Verification Modernization Act of 2017, requiring the IRS to automate the Income Verification Express Service process by creating an API, or application programming interface, which would reduce the paperwork and the waiting period that currently burdens lenders and borrowers alike.

Second, working with the New York Business Development Corporation, we have identified an opportunity to increase referrals of those borrowers unable to gain access to credit through traditional methods to a mission-based nonprofit lender by providing Community Reinvestment Act, or CRA, consideration for referrals. Currently, banks do not receive CRA credit from referring borrowers to CDFIs or other qualified institutions when these loans are too risky for the bank to underwrite. Given the economic development missions of CDFIs to support small businesses, a successful referral from a bank is something that regulators should incentivize.

Third, the law should allow credit reports to travel with referred loan applications. When applying for a loan, numerous credit inquiries occur from the various lenders considering the borrower's request even though the borrower is seeking a single loan. Currently, each lender has to pull a credit report even if the loan is a referral. The more inquiries, the greater the impact on a credit score. As a credit score gets lowered, the cost of capital increases and becomes more difficult to obtain.

Finally, I encourage you to further incentivize the SBA to improve their technology in making the agency's lending process more efficient and borrower-friendly. SBA-backed products remain a vital source of capital for small businesses, particularly newer businesses and startups. However, the process and technology used are cumbersome and can deter many lenders and borrowers from par-

ticipating. The private sector, including Mirador, has developed world-class matching technology, ensuring that borrowers end up approved by a lender under the most appropriate terms and conditions. The SBA should be encouraged to look to the private sector for technology solutions to improve the borrower experience in their flagship programs, SBA One and SBA Lender Match.

Once again, thank you so much for this incredible opportunity, and I am happy to answer your questions.

Chairman BRAT. Super. Thank you, Mr. Dryer. We appreciate your testimony as well.

And I think for the questions I am first going to yield to my colleague Mr. Luetkemeyer. He has a special interest and expertise in this area, and we will lead off with some questions.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I appreciate the opportunity to be here today in your Committee.

Ms. Fisher, I am kind of curious, you are advocating, or represent anyway, the merchant cash advance folks. Is that correct?

Ms. FISHER. Yes.

Mr. LUETKEMEYER. Would you describe a cash advance as a loan or an investment? Or how would you classify that?

Ms. FISHER. Sure. Thanks for asking that.

A merchant cash advance is not a loan. It is a purchase of the right to receive future income from a business. So a small-business owner can enter into a transaction with a merchant cash advance funder under which the small-business owner sells a percentage of its future income. And the merchant cash advance company then will receive that portion of the small business' revenue as the small business makes the revenue.

It is a very helpful product for small businesses, in that payments are not unconditionally required. The payments to the merchant cash advance company are required only to the extent that the small business actually creates revenue.

Mr. LUETKEMEYER. Okay. Fantastic.

So I know that in Mr. Phalen's testimony he talks about a SMART Box. And I am all for disclosures. I think the individual, the business needs to know what they are getting into. I think that is important. But I know in the SMART Box there is an APR disclosure. How do you disclose an APR with a merchant advance product?

Ms. FISHER. That is a good question. A merchant cash advance product is not an appropriate—

Mr. LUETKEMEYER. It is not a loan, so, therefore, you don't really have an APR, right?

Ms. FISHER. And, also, there is no definite term.

Mr. LUETKEMEYER. Okay.

Ms. FISHER. So, because a small business is required to deliver a portion of their receipts as those receipts are created, we can't know when those receipts will be created. And things can happen; like, there can be a tough winter in Minnesota and business slows down for businesses there and so receipts trickle in more slowly than expected.

So putting an APR as a measurement on a transaction with no definite term is not the most helpful—

Mr. LUETKEMEYER. We are trying to fit a square peg into a round hole, aren't we?

Ms. FISHER. Yeah.

Mr. LUETKEMEYER. You know, I deal with a lot of small-dollar lending, and I chair the Financial Institutions Subcommittee in Financial Services, and so I deal with this stuff all the time. You know, for a long time, I—and I actually chaired the Financial Services Committee back in Missouri when I was back in the State house. And I have always dealt with the problem with APR disclosures for small-dollar lending anything less than a year. You know, APR, the letters stand for "annual percentage rate." How do you have an annual percentage rate on something that is not done on an annual basis? It is done for 2 or 3 weeks or 6 months at a time. I really struggle with this.

And I think, you know, quite often, the APR has been misrepresented. Because, at the end of the day, if I have a leaky faucet at home and I call my plumber up and he charges 50 bucks, you know, to stop by my doorstep—if goes in and says, "Oh, you have a tap I just have to fix," so within 5 minutes, you know, 10 minutes there, he fixed my faucet, now, did he charge me 50 bucks to stop by and pay for his trip out and his experience and all his tools and all of that, or did he charge me \$300 an hour?

That is the disproportionality of an APR and the misrepresentation of what is going on with this service charge for small-dollar lending, which, you know, in your situation here, quite frankly, isn't going to apply because of the business model that you have.

So that is my concern with APRs. I think for small-dollar lending or anything that is less than a year, I think it is an irrelevant thing. And I hope that that can be something that a SMART Box can be able to be fixed so it doesn't do more harm than good, because I think it misrepresents what is actually going on there.

Mr. Dryer, you made a comment a minute ago with regards to credit bureau inquiries. And I think this is a very, very important point, from the standpoint that the more inquiries that an individual has or business has, it sometimes can have a negative impact on that person or that business' ability to get credit. Would you like to elaborate on that just a little bit?

Mr. DRYER. Sure.

Mr. LUETKEMEYER. It seems counterintuitive, because you are trying to find a way to help people, and actually hurt them by going through the credit bureau.

Mr. DRYER. That is right. We see, typically, because of the rules that don't allow one lender to share a credit report with another, that small businesses often have to apply to several lenders in order to find one that fits their credit parameters, their lending parameters. And so you will see sometimes, when they are looking for the same \$50,000 loan, they had to apply to five or six lenders, and, as they go through the process, more credit inquiries, lowering their FICO score, which—

Mr. LUETKEMEYER. So how would you fix that for your small businesses? Because this is really important, because they are trying to get started, they are struggling, and yet if they actually try and go someplace and get some funds and that individual or com-

pany or entity goes to the credit bureau, it is actually a mark against them. How do you solve that problem?

Mr. DRYER. I would solve it by allowing the credit report to be transferred from lender to lender. If you are applying for a single loan, even if it is with multiple lenders, that should be one credit inquiry, in my view. And if you can allow the borrower to kind of take that data with them, that would, I think, solve, largely, the problem.

Mr. LUETKEMEYER. I appreciate that.

Thank you, Mr. Chairman. My time has expired.

Chairman BRAT. Thank you.

I will now yield to the ranking member, Mr. Evans, for 5 minutes.

Mr. EVANS. Thank you, Mr. Chairman.

Ms. Fisher, I wanted to probe a little bit more on what my colleagues just talked about. When applying for finance, does your industry get personal guarantees that lenders and other industries receive?

Ms. FISHER. Thank you for that question.

In the merchant cash advance industry, there typically are personal guarantees, but they are of a different sort than with a loan. As I explained before, with a merchant cash advance transaction, the business is only obligated to deliver revenue to the extent the business creates that revenue. So the personal guarantee is not a personal guarantee of payment.

The business owner also makes certain promises, such as they won't divert revenue, you know, they won't open multiple bank accounts and do funny things with their money. So the guarantee is a guarantee of those types of promises, not the guarantee of repayment.

Mr. EVANS. So does that lack of collaboration affect your business model?

Ms. FISHER. No. I think it affects it in a positive way, in that it helps only ensure that the business owner, who typically is the person who can control in a small business whether they are opening multiple bank accounts, is standing behind those promises. But it doesn't change the nature of the product being not absolutely repayable.

Mr. EVANS. Uh-huh.

This is to the entire panel, and I will start with you.

Are you aware of the Small Business Borrowing Bill of Rights? And do you think its tenets include commonsense tools to protect small businesses and provide transparency?

Ms. FISHER. Thank you.

I am aware of the Small Borrowers Bill of Rights. I haven't read it in a while, so I am not familiar with exactly what it says. I think that, as I recall, there are certain things about it that are very good. There are certain things about it—I think it mentions APR, so that would be something that I would disagree with.

The good news is there are many different industry groups who are working on best practices. And, although they don't agree with every practice, they are working hard on coming together for best practices as a whole. So that is a positive thing.

Mr. EVANS. Okay.

Other people want to respond to that?

Mr. PHELAN. Sure. Yes. Thank you, Congressman.

We also are aware of all the different disclosures that are underway now in the industry, and I mentioned some of them in my opening remarks. And there are different tools for assessing the cost of these types of loans. We think that the more those tools are made available, the better for the businesses to assess the cost of credit.

I think somebody here mentioned that businesses have all kinds of credit needs and financial needs, and it is hard to distill this down into any one kind of point of view that can encompass all these different capital needs or credit needs for businesses. And so, providing the disclosure and having the tools available make a lot of sense as a way to help clarify the cost for the business.

Mr. EVANS. Mr. Dryer?

Mr. DRYER. Yes, we applaud the efforts of the industry to create more transparency and disclosure. At the end of the day, that, to me, is what is important, is the small business understanding what they are getting into.

I think the challenge is, when you have regulated entities that are subject to regulations requiring a certain disclosure and then you have industry groups that have taken a different approach, it can become very confusing for a small business if they are looking at multiple lenders to really understand the true costs and the terms of the loans. And we see that can be, you know, quite confusing.

I don't have a great solution for that, but I think the more that a small business can be allowed to, you know, compare proverbial apples to apples, the better it is for the borrower.

Mr. EVANS. Thank you.

Mr. Chairman, I yield back the balance of my time.

Chairman BRAT. Thank you, Mr. Evans.

I think we are actually doing all right on the voting clock. They are still talking on the floor, so we have done well today.

I will ask a bit of a technical question, and then in the back of your minds—you are up here in D.C.; Federal Government, Federal law, et cetera, regulations. At the end, maybe just suggest how we can be helpful to you moving forward, what we can do better, and that.

But I will just start off with more of a narrow question. We will start with Mr. Phelan and work down.

Currently, the Consumer Financial Protection Bureau, CFPB, is in the process of implementing Section 1071 of Dodd-Frank, which would require financial institutions, including online lenders, to gather and submit demographic data of borrowers to the government.

What concerns, if any, do you have with this provision? And how would it affect both small financial institutions and small businesses?

Mr. PHELAN. Thank you for that question.

Yes, we have worked a little bit with the CFPB to help them understand this data-collection requirement. It is complex, and what we find is that the data doesn't exist today, so it is hard to say where exactly to go to obtain it right now.

We think that the challenge is in creating this massive set of information and that, it is going to put a burden on the businesses, ultimately, to report this in the transaction. There will be some requirements to collect it directly from the business. The business is really the only source to get it, because no other sources exist right now.

Then there is the challenge of being able to create this massive data warehouse. And there are different ways to do it. What we have discussed with the CFPB, is to utilize current technology that exists right now to collect this information. And once that is collected, it must then be crafted into a finished product that provides an understanding of what is going on in the lending markets and to understand fair credit, lending activity.

So the concerns are that it is going to be a massive project, and it is going to be a very substantial change for both the business and, I think, even to the CFPB to thoroughly understand the information from this data set.

Chairman BRAT. Great. Thank you much. I apologize for the alarm. I have never heard it go off like that before.

But I think I am going to yield my time to Member Yvette Clarke from New York right now. She is with us, and I want to make sure we get her questions in, if she has any for you today. Thank you.

Ms. CLARKE. Certainly. I thank you very much, Mr. Chairman, and I thank Ranking Member Evans.

I thank our expert witnesses for appearing here today.

We know that the world has changed dramatically over the past decade alone. We have seen rapid technological advances that have allowed us to access the world in the palm of our hands. However, we have also seen generations of family wealth wiped out due to the mortgage foreclosure crisis.

At the center of all of this lies the financial technological industry. This crucial industry offers the promise of easier access to capital for people to open businesses, afford college, and launch new products. However, it also means that lenders could be exposed to new forms of fraud and borrowers could face new forms of soft discrimination/implicit bias by focusing on nontraditional lending factors that structurally disadvantage specific communities.

Our goal as elected Representatives of the American people is to ensure that the government creates clear, fair, and effective rules to maximize access to capital while minimizing risk and discrimination that results from bias.

So my first question is to Mr. Phelan.

Can you please describe what nontraditional factors FinTech lenders may look toward in making investment decisions? For instance, is there some means of explaining the story behind late payments within the confines of your application process?

Mr. PHELAN. Thank you. Thank you for that question.

First, I will start with just the nature of a small business. A lot of times, small businesses lack the financial statements in an audited format. They don't really have the need to present audited financial statements and undertake all that expense that a public company does. With that as a starting point, lenders are looking to do a credit assessment. They are looking to conduct an assessment about the ability to repay the loan.

So, if you put those two together, first you have to go to various sources of data to assess the credit of the borrower. And these sources provide information mentioned in the credit memo, things like credit bureau information, both on the personal and the commercial side. There is commercial credit data that can be used very effectively. Secondly, there are very creative things done by the FinTechs around collecting financial cash-flow information through the bank statements. They can actually look at the cash flows of the business through the bank statements.

There are other sources that I think have been more hyped than reality, things like social media, that are interesting from a credit assessment standpoint, but are unproven. And so I think those are challenges that have not really been fully vetted yet.

And then there are other forms of payment records, like the short-term trade payable information, such as shipping bills, phone bills, light bills, things like that.

What I think is interesting about online lending is that the online lenders really never see their applicant. They don't meet them face-to-face, which is far different than the community bank structure. In the community bank, you walk into the branch, you meet the banker face-to-face. And with the online lenders, this is all done online. It is all done really through the information and data that doesn't provide a view into the business itself and important characteristics, other than, you get name, address, phone number, and name of the business. You get the payment records and maybe some public filing information, too. And so that can be distilled down to create some very credible and reliable credit assessments.

Ms. CLARKE. Very well. Thank you.

Ms. Fisher, in your prepared testimony, you went into detail about the complexity of merchant cash advances, which allows for businesses to sell their future receipts for cash up front. Yet you also claim they are already sufficiently regulated at the Federal and State level.

Are there any changes that you would like to see made to the way in which the government regulates MCAs?

Ms. FISHER. Thank you for that question.

My view is that Federal regulation of merchant cash advances is sufficient. There are Federal laws that touch the merchant cash advance transaction, as I mentioned, throughout the transaction, from marketing to underwriting to servicing and collection. So I don't have any suggested changes.

Thank you.

Ms. CLARKE. Very well.

Mr. Chairman, I yield back. Thank you.

Chairman BRAT. Thank you very much.

And sorry for the rushed feel today. I apologize. On fly-out days, we usually leave about noon, but, today, for some reason, it happened a little early. And so I just want to thank you all for your participation and good spirits today and the excellent testimony you all provided.

I ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 10:42 a.m., the Subcommittee was adjourned.]

A P P E N D I X

Testimony of

William Phelan
President and Co-Founder, PayNet, Inc

Before the

United States House of Representatives
House Committee on Small Business

Hearing on

Financing through Fintech: Online Lending's Role in
Improving Small Business Capital Access

October 26, 2017



**Testimony of William Phelan
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**Before the United States House of Representatives
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Overview

Post financial crisis of 2009 clearly resulted in disruptions in the credit market for small businesses as traditional sources of credit like community, regional and large banks could no longer profitably supply credit or they were preoccupied with other more pressing issues in their businesses. Partly due to the JOBS Act and partly due to new applications of technology, innovators in the form of fintechs invented new ways to provide credit to small businesses to fill this “credit gap”. Fintechs have faced the challenge of building systems for sourcing borrowers, finding the capital to make loans and building the technology platforms to lower the cost of processing a credit application. They have excelled at building technology platforms to lower the cost of providing credit applications to small businesses but as a group, they still face high costs to find prospective borrowers and they face high costs of capital as a source for their loans. I note that since the dawn of fintech, several have decided to exit this market or they have gone out of business themselves.

It is clear that fintechs have not fully realized the potential they held several years ago when many equity analysts predicted fintech would transplant banks as a primary source of credit to small businesses. But fintechs have provided three critical benefits to the supply of credit to small businesses: first, they have figured out technology platforms to lower the cost of processing a credit application; second, they have changed the expectations among small businesses for access to and speed for working capital credit, which traditional sources cannot afford to offer at a reasonable cost; third, they are filling the credit gap faced by small businesses across the credit spectrum and industry sectors. More work must be done by these innovators to improve their business models and I note that many fintechs are themselves small businesses.

Improvements in fintech business models include cheaper sources of capital that can be the source for lower priced loans. Another major improvement necessary for fintechs to become a long term source of credit for small businesses is to lower the cost to acquire their customers who are the prospective business borrowers. Also, many fintechs are addressing the capital and customer acquisition business issues through partnerships with banks. Most importantly, they must continue to work on their business methods to provide transparency, such as that provided by the ILPA through its SMART Box, on the terms of loan contracts with small businesses. Like any market of suppliers, lenders to small businesses provide varying degrees of information about their product to ensure their loan contracts are fit for the intended purpose. My concern is that fintech, in its early stage of development, could fail as an industry to fill the credit gap. This failure could result from lenders who do not fully inform borrowers on the terms of their loan contracts and in doing so, create the impression that all fintech lending is an

untrustworthy source of credit. This could drive away other lenders that are providing better disclosure about the terms of their contracts and seeking to lower the cost of delivering credit to small businesses. In this scenario of market failure, less supply of credit becomes available for small businesses and further enlarging the credit gap.

Introduction and Purpose

Members of the Committee, my name is William Phelan, President, and Co-Founder of PayNet, Inc. based in Skokie, Illinois, a suburb of Chicago. I appreciate the opportunity to speak today on behalf of PayNet, Inc. which provides small business credit information to banks, commercial finance, alternative lenders and corporate credit lenders throughout the nation. PayNet, Inc. is a member of the U.S. Chamber of Commerce and I am active on a number of boards in addition to my role operating PayNet on a day to day basis. My board participations include The Canadian Leasing and Finance Association (CFLA), The Innovator Lender's Platform Association (ILPA). I was formerly on one of the Advisory Boards for the Chicago Federal Reserve Bank and for the Equipment Leasing and Finance Association (ELFA). I speak regular at industry events and in the business community on the topic of access to credit for private companies in the U.S. and Canada. My role today is to provide a perspective and impact of fintech on credit and capital availability to the small business economy.

Background

Access to small business credit information increases access to capital, spurring economic growth and jobs, and significantly reduces the cost of doing business. PayNet collects and tracks this data on small business loans from hundreds of U.S. and Canadian lenders each month, turning it into actionable intelligence.

PayNet, Inc. maintains a repository of historical payment information on small business loans; collecting real-time small business loan and lease information from more than 300 leading U.S. lenders. PayNet's data provides a unique window into the world of small business lending/credit trends compiled from our "real-time" proprietary database consisting of over 24 million term debt contracts worth nearly \$1.5 trillion in loan value.

Key statistics about the PayNet Database are as follows:

- Average number of months of history per lender is 117.
- Database contains nearly \$1.5 trillion in financial obligations.
- Average transaction size per contract is \$67,056.
- Average term per contract is 3.7 years.
- Average monthly payment per contract is \$1,524.

Small Business Credit

Small businesses in America are a primary driver of economic growth and have become the centerpiece of the economic recovery. According to the U.S. Small Business Administration's Office of Advocacy's most recent estimate, 29.6 million businesses operated in the U.S. in 2014.

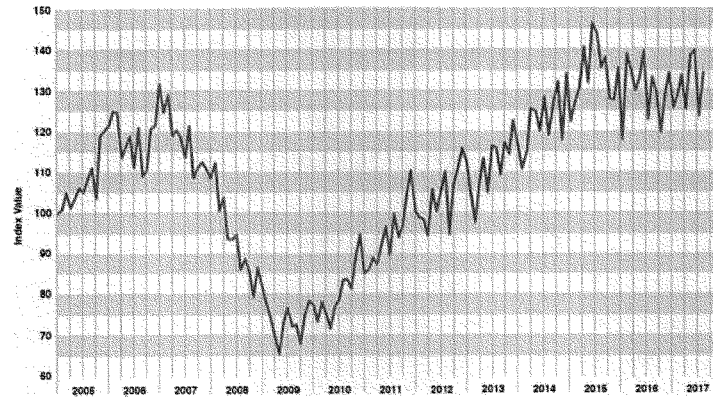
The perplexing aspect of the small business economy is not its importance as the engine of U.S. growth, innovation, and competitive edge, but how little we know about this important economic engine. Limited knowledge hinders the ability of bodies such as this Committee to create policies that help small businesses.

Much interest exists now to better understand the small business credit market. This interest is driven in part by research showing the credit gap exists in the form of disruptions of credit access to small businesses. Research shows this credit gap has been shown to restrict economic growth and wage growth. While difficult to predict with exact science, the impact of the credit gap has most likely contributed to what many consider to be sub-par growth of less than 3% in the U.S. GDP over the past several years. Disruptions in the market mechanism that operated and provided credit to small businesses pre-recession are one likely cause of this gap, as big banks pulled out of local markets and community banks consolidated their operations and focused on meeting compliance requirements.

Small Business Credit Conditions

The August 2017 Thomson Reuters/PayNet Small Business Lending Index (SBLI), which measures the volume of small business loans issued over the past 30 days, increased 8% to 134.2 in August 2017 from 123.8 in July 2017. Compared to August 2016, the SBLI increased 1%.

Thomson Reuters/PayNet Small Business Lending Index (SBLI)
(January 2005 - August 2017)



Top growth sectors driving investment expansion by small businesses were found in the Construction (+6%), and Accommodation & Food Service (+6%) businesses which together represent over 13% of the small business economy. Arts, Entertainment & Recreation (+10%) remained the top growing sector among small businesses. In a big turnaround, Mining (+3%) and Wholesale trade (+3%) were both positive for the first time in the last several years.

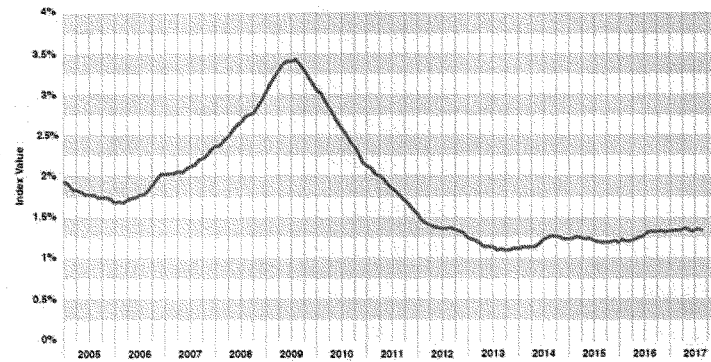
After many months of double-digit contractions, growth in the Health Care sector stabilized dramatically, and has been slightly positive in recent months with a 0.2% increase.

Similar to last month, growth continued to be strongest in the Western Part of the South as well as the eastern part of the Midwest, likely reflecting in part the acceleration in global growth this year and the regions' exposure to globally-oriented industries such as mining and manufacturing, respectively. Additionally, the Pacific portion of the west coast is starting to show material signs of strength in the most recent couple of months. The mid-Atlantic is the one region of the country where contractions continue to persist with little signs of abatement, although the most recent results were somewhat positive.

The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI) 31-90 days past due, which measures the percentage of loans that are delinquent, decreased to 1.33% in August 2017 from 1.35% in July 2017. Compared to one year ago, delinquency increased by 1 basis point (bp). Transportation showed a 10 bp decrease in delinquency. Increases in delinquency are shown in both Agriculture (2 bps) and Construction (1 bp).

Thomson Reuters/PayNet Small Business Delinquency Index (SBDI)

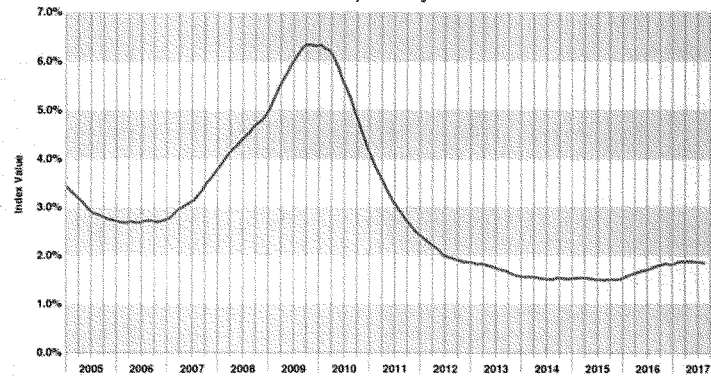
(31 - 90 Days Past Due)
(January 2005 - August 2017)



The PayNet Small Business Default Index (SBDFI), which measures the percentage of loans and leases to small businesses that have defaulted, at 1.84% is 35% below pre-crisis readings, and has been receding in recent months.

PayNet Small Business Default Index (SBDFI)

(January 2005 - August 2017)



Much of the improvement in recent months has come from two formerly high-risk sectors experiencing lower default rates. Mining default rates have declined approximately 1%-point

over the last year, and Transportation default rates have been declining at a 0.6% annualized rate over the last three months. Conditions are in place for small businesses to drive GDP growth resulting from exceptional financial health.

Most other sectors, with the exception of Agriculture, have current default rates that are around 25% to 75% below pre-crisis levels. Information Services continues to show a dramatic deterioration in default rates in recent months, but no other sector has seen its default rate rise at even a 0.4%-point annualized rate over the last three months.

Similar to originations trends, default rates are currently declining rapidly in the Western part of the South. In fact, they have been declining at a nearly 1%-point annualized rate in that region over the last three months. Despite these recent improvements, however, the region's default rate stands 80 basis points above the next closest region.

Many other regions with exposure to globally-oriented sectors, such as the Midwest and the Mountain portion of the West Coast, have also been experiencing stabilizing or declining default rates in recent months. By contrast, some deterioration in financial conditions is present in both the Northeast as well as the Pacific portion of the West Coast. Default rates remain lowest in the New England region and the Midwest generally.

Credit conditions for small businesses in 2017 indicate less investment for growth but higher financial quality compared to pre-financial crisis. We see in the data that growth rates nearing 12% for the period 2005-2017 versus -1% for the period 2015-2017. While investment growth remains tepid, financial health stands stronger than the pre-financial crisis period. The net result shows that small businesses as a group remain reluctant to invest in growth projects at a time when their financial health has improved.

Market Size Estimates

The small business lending market is vast. According to the FDIC, there were \$180 billion in business loan originations under \$250,000 in the United States in the fourth quarter of 2014, across 22.1 million loans. Oliver Wyman estimates the potential for \$80 to \$120 billion in unmet demand for small business lines of credit, and we believe that there is also substantial unmet demand for other credit-related products, including term loans. We also believe that the application of technology to credit assessment can expand the total addressable market for small business credit.

In 2013, the Federal Reserve estimated gross shadow banking liabilities in the U.S. (their measure of non-bank credit intermediation) at roughly \$15 trillion, down 30% from a peak of \$22 trillion in 2007 (vs. bank liabilities growing from \$14 trillion to \$16 trillion over the same period). The contraction of shadow banking liabilities is not surprising considering that the Fed's

broad definition includes all structured credit (including asset backed securities now consolidated on bank balances following accounting rule changes), as well as commercial paper, repo and money market mutual funds. Additionally, during the financial crisis, several of the largest non-banks (particularly the investment banks) converted to Fed-regulated bank holding companies, further reducing the shadow bank universe. ("The Future of Finance, The Rise of the New Shadow Bank", Ryan M. Nash and Eric Beardsley, Goldman Sachs, Equity Research, March 3, 2015.)

PayNet analysis offers another view of the small business credit market with estimates of the size of the credit markets in the commercial finance, commercial bank, and alternative lender segments. The analysis was conducted for two segments: facilities up to \$1 million and up to \$250,000.

| <u>Segment</u> | <u>Balance (\$Bil)</u> | | <u>Contract Count (Thou)</u> | |
|----------------------------|-------------------------|-------------------------|------------------------------|-------------------------|
| | <u>\$250k and Under</u> | <u>\$1mil and Under</u> | <u>\$250k and Under</u> | <u>\$1mil and Under</u> |
| Commercial Finance | \$ 163 | \$ 242 | 6,760 | 7,070 |
| Commercial Bank * | \$ 311 | \$ 695 | 26,550 | 27,710 |
| Alternative Lending (2016) | \$ 6 | \$ 7 | 180 | 180 |
| Total | \$ 481 | \$ 944 | 33,490 | 34,960 |

*Agriculture and Farmland Loans only go up to \$500K in the FDIC data

For the larger \$1 million and under segment, the analysis shows an estimated \$944 billion in outstanding loan amounts in these three segments of the market. Based on this market size this equates to over 35.0 million financial contracts. For the \$250,000 and under segment, the analysis shows an estimated \$481 billion in outstanding loan amounts. Based on this market size this equates to over 33 million financial contracts.

Given that the SBA has estimated that other sources of capital such as mezzanine and buyout, angel capital, and venture capital have comprised approximately 13% of the total small business financing in recent years, the total small business financing market could equal approximately \$1.1 trillion.

While credit unions do not have readily accessible breakouts of their business loans by deal size, business loans represent approximately \$74 billion in outstanding value as of June 2017, presumably a material share of which fits into the small business category. Small business lending grew by 130% between mid-2007 and the end of 2015 according to CUNA Vice President Mike Schenk.

As data on small business lending remains elusive, we used various methods to size this market, which are detailed in the appendix at the end of this testimony. Regardless of the assumptions

used, however, it is clear that the small business credit market represents a sizeable proportion of the US economy and one that is integral in driving growth and prosperity.

The Small Business Credit Market Mechanism

The market mechanism by which small businesses access credit consists of commercial lenders and businesses that finance the purchase of their goods and services. Commercial lenders and businesses employ various methods to provide credit to small businesses. Small business lending has historically been expensive because of its diversity and loan size. Corporate credit underwriting requires 28 separate tasks to arrive at a decision. These 28 tasks involve collecting information for the credit application, reviewing the financial information, data entry and calculations, industry analysis, evaluation of borrower capability, capacity and valuation of collateral. A time series analysis of these steps reveals a 2-3 week process at best and in some cases as much as eight weeks to arrive at a single credit decision. Three major departments of the bank play a role in the process – relationship manager, credit analyst, and credit committee.

Costing out this process shows a cost of \$4,000 to \$6,000 to underwrite each credit application. With these costs, banks are unable to turn a profit on this business unless the loan size exceeds \$500,000. The following chart shows these costs in detail:

Table 1: Corporate Credit Underwriting Cost per Application

| MANUAL PROCESS | | | |
|----------------|---------------------------------------|-------------|-------------------|
| People | Task | Time (hrs) | Total Cost (\$) |
| Loan Officer | Credit Application | 5.8 | \$414.66 |
| Credit Analyst | Reviews | 19.0 | \$1,196.15 |
| Credit Analyst | Data Entry and Calculations | 46.0 | \$2,803.85 |
| Credit Analyst | Industry Risk Analysis | 16.0 | \$1,323.08 |
| Credit Analyst | Borrower capability | 2.0 | \$115.38 |
| Credit Analyst | Valuation and liquidity of collateral | 10.0 | \$726.92 |
| Total | | 98.8 | \$6,994.71 |

There is nothing wrong with this corporate credit underwriting process for large middle-market and corporate lending, but when it is applied to smaller commercial credit, it clearly works as a disincentive to the bank and to the loan officer.

Loan review is another process that has made commercial lending unattractive because it adds a significant scope of work to credit administration. An effective loan review program provides senior management and the board of directors with a timely and objective assessment of the

overall credit quality of the portfolio. Appropriately grading loans enables the bank to take timely steps to minimize credit losses. Similarly, it is important to identify trends that affect the collectability of loans in the portfolio and recognizing segments of the portfolio that are or have the potential to become problem areas.

The key to an effective loan review system is accurate loan classification or credit grading. Here again, the typical corporate credit process makes accurate risk ratings a major challenge for banks because of the sheer number of credits in a robust commercial lending business. Analysis shows that one loan review involves 15 separate steps, from collecting and spreading financial statements to conducting cash flow analysis and adjusting risk ratings. Three major departments are involved in this process, including the lending group, credit and audit groups. A single loan review can take a bank up to two days of work to complete at a cost of over \$1,000 as shown below:

Table 2: Loan Review Cost per Customer

| People | Task | Time (hours) | Internal Costs (\$) | External Costs (\$) | Cost (\$) |
|----------------|---------------------------|--------------|---------------------|---------------------|--------------------|
| Loan Officer | Department Total \$ / App | 7.75 | \$ 372.60 | \$ 250.00 | \$ 622.60 |
| Credit Analyst | Department Total \$ / App | 4.00 | \$ 153.85 | \$ 100.00 | \$ 253.85 |
| Administration | Department Total \$ / App | 4.00 | \$ 153.85 | \$ - | \$ 153.85 |
| Sales | Department Total \$ / App | 1.50 | \$ 57.69 | \$ - | \$ 57.69 |
| | Totals | 17.25 | \$ 737.98 | \$ 350.00 | \$ 1,087.98 |

This means that a bank with 1,000 commercial customers will incur over \$1 million in costs to conduct annual loan reviews. In some cases, regulators are requiring more frequent reviews which can double the cost, even as banks are trying to cut costs to boost profitability.

The Credit Gap

One key feature of the market mechanism has been community banks that operate in local markets through a high touch business model. The consolidation of community banks has most likely stood as one cause of the credit gap. The number of community banks has shrunk by more than a third since 2007. Anecdotally we find that community banks are concentrating on loans with a minimum value of \$500,000 or more because smaller balance loans are not profitable.

A recent study quantifies how a sharp downturn in small business lending activity from the four largest banks in the US (Citi, Wells, JP, B of A) affected economic outcomes as well as how other

nonbank lenders responded to this sharp pullback in small business lending activity from the Big 4 Banks. (“The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets”, Brian S. Chen, Harvard University; Samuel G. Hanson Harvard Business School and NBER; Jeremy C. Stein Harvard University and NBER in March 2017).

The motivating statistic for this study was the fact that small business originations (less than \$1mil) for the Big 4 banks were just 50% of their 2006 level as late as 2014, which was only a small tick-up from the nadir in 2006 based on Community Reinvestment Act data. This was a far more severe decline than other banks’ pullback in the data set, which saw originations reach 80% of 2006 levels as of 2014. On average, small business lending fell 30% more at the Top 4 Banks than at other banks in the CRA database

The authors found Small business lending by the four largest U.S. banks fell sharply relative to other banks beginning in 2008 and remained depressed through 2014. They explored the consequences of this credit supply shock, with a particular focus on the resulting dynamic adjustment process. Using a difference-in-difference approach that compares counties where the Top 4 banks had a higher initial market share to counties where they had a smaller share, they found that the aggregate flow of small business credit fell and interest rates rose from 2006 to 2010 in high Top 4 counties. Economic activity also contracted in these affected counties: fewer businesses expanded employment, the unemployment rate rose, and wages fell. Moreover, the employment effects were concentrated in industries that are most reliant on external finance, such as manufacturing. They further explored how high Top 4 counties adjusted to this shock from 2010 to 2014. While the flow of small business credit has slowly recovered in affected counties—as smaller banks, non-bank finance companies, and online lenders have filled the void left by the Top 4 banks—loan interest rates remain elevated, suggesting that credit conditions are still tighter in these areas. Moreover, although the unemployment rate returns to normal by 2014 in high Top 4 counties, the effects on wages persist, suggesting that more expensive credit may have led small businesses to become less capital intensive which in turn suppressed productivity.

With the consolidation of community banks since 2007, the number of traditional loan sources for small businesses shrank 35%, contributing substantially to the small business credit gap. The community banks that are still in operation are going up-market to more profitable loans, with a minimum size of \$500,000, in response to increased capital requirements for higher risk loans and greater regulatory scrutiny. The time, paperwork and cost of more than \$5000 for a bank to even process a loan are factors causing a barrier between small businesses and their bankers.

Fintechs that use software, data, and analytics to deliver credit faster and with less paperwork are part of the emerging small business credit market providing new sources of capital.

Fintech Lender Business Overview

Marketplace lending is a new source and method for providing capital to businesses and consumers. It rose from the JOBS Act which authorized new methods to provide capital after the Great Recession. Providers of credit latched onto some of the concepts outlined in the JOBS Act as ways to access funding and to provide loans at low cost. The term marketplace refers to a broad category of companies that provide direct lending, peer to peer lending and referrals. Credit providers use a combination of technology, data and analytics and traditional credit systems, thus are often associated with the term “fintech,” to process loan applications at lower costs than a traditional underwriting process generally favored by banks. Size estimates for the credit market vary by source, but the general consensus among all is that marketplace lending will grow to become a substantial and established provider of credit for consumers and businesses over the next 5 years.

Fintech’s share of the small business lending market are generally estimated to be \$5B to \$7B of small business loans (“Alternative lending - Commoditizing loan applications through technology while paving the way for big data investing”, Ernst & Young, 2016). Fintech’s share of small business originations is estimated to grow to \$50B by 2020 (Business Insider - One area of US alt lending is recovering, Feb. 2017).

Morgan Stanley estimates the size of global marketplace lending can reach \$290 billion by 2020. They estimate a 51% CAGR through 2020 after growing at a 123% CAGR 2010-14. Most of this growth is estimated to occur in the U.S. and China. Morgan Stanley estimates marketplace lending will approach \$150 billion by 2020. Morgan Stanley estimates TAM of 184 Billion in outstanding loans with 100 Billion in unmet demand, SME marketplace lending represented \$4.6 Billion on 2014 and is expected to reach \$47 Billion or 16% of total US SME issuance in 2020, primarily on new credit expansion. This is a significant impact on addressing unmet credit demand for the SME segment.

| LOAN TYPE | TOTAL MARKET (\$ billions) | 2014 (\$ billions) | EST. GROWTH % 2020 |
|--------------------|-------------------------------|-----------------------|-----------------------|
| Unsecured Consumer | \$450 | \$7.4 | 47% |
| Small Business | 280 | 4.6 | 47% |
| Student Loans | 400 | 2.2 | 40% |
| Mortgages | 1,000 | 14.0 | na |
| Autos | 250 | 1.6 | na |

Products and Terms

Products are traditional loans with non-traditional repayment. Loans are used by businesses to fund working capital and to buy equipment. Loan amounts are offered up to \$2 million but we

see the average around \$60,000 with the balance increasing. We see loan terms offered up to 5 years but the actual maturities average less than 1 year but term is increasing.

Most lenders offer fixed term loans. The principal amount of each term loan ranges from \$5,000 to \$2 million. The principal amount of the term loan is a function of the requested borrowing amount and credit risk assessment of the customer's ability to repay the loan. The typical term loan ranges from 3 to 24 months. Some lenders provide highly tailored loan terms to differentiate their product and meet the specific nature of many customers' borrowing needs. Term loans are repaid through fixed automatic ACH collections from their business bank account on either a daily or weekly basis. Term loans are originated directly or through issuing partners such as banks and loans that are purchased from the issuing banks have similar performance to internally originated loans.

Another major loan product is a revolving line of credit with fixed six-month level-yield amortization on amounts outstanding and automated weekly payments. These credit lines range from \$10,000 to \$25,000. A customer may be offered a line of credit based on the credit risk assessment of the customer's ability to repay the line of credit. Line of credit products are typically issued directly to borrowers, rather than through bank partners.

Several coalitions of fintech lenders have arisen to provide increased disclosure of their loan products to prospective small business borrowers. The Innovative Lenders Platform Association (ILPA) offers the SMART Box™ (Straightforward Metrics Around Rate and Total cost) to compare loan pricing and enhance disclosure standards. The SMART Box offers pricing metrics, calculators, and explanations to help small businesses understand and assess the costs of their small business finance options. Responsible Business Lending Coalition (RBLC), a network of for-profit and non-profit lenders, brokers and small business advocates offers The Small Business Borrowers' Bill of Rights. The Small Business Borrowers' Bill of Rights identifies 6 rights for small business owners along with the specific practices that lenders and brokers must abide by in order to uphold and protect those rights. It is important to note that these enhanced disclosure such as the SMART Box and The Small Business Borrowers' Bill of Rights are not intended to replace a lender's existing disclosures rather they are supplemental disclosures.

| Lender | Loan Type | Amount | Term | Repayment | Other | Origination Fee | Personal Credit |
|-----------------------------|-----------------------|-----------------------|-----------------|-----------------|---------------------|-----------------|----------------------------|
| OnDeck | Term Loan, LOC | \$5,000 - \$500,000 | 3-36 months | Daily or Weekly | \$20/mo | 2.5% to 4% | 500+ |
| Lending Club | Term Loan | \$1,000 - \$300,000 | 12 - 60 Months | Monthly | Draw fee 1% to 2% | 0.99 - 5.99% | fair personal credit |
| IOU Central | Term Loan | \$5,000 - \$300,000 | 6 or 18 month | Daily or Weekly | Small guaranty fee | 8.80% | No specific minimum |
| Business Financial Services | Term Loan, MCA | \$5,000 to \$2M | 3.5 - 36 Months | Daily or Weekly | Small fee | 2% to 6% | above 475 |
| CAN Capital | Term Loan, MCA | \$2,500 to \$150,000 | 4 to 24 months | Daily | Application fees | 3.00% | Better than average credit |
| Fundation | Term Loan | up to \$500,000 | 12 - 48 Months | Twice a month | Application fees | 5.00% | Good credit |
| Funding Circle | Working Capital Loan | up to \$100,000 | 18 Months | Monthly | 2% per draw | \$500 | Good credit |
| Funding Circle | Term Loan | \$25,000 to \$500,000 | 12 - 60 Months | Weekly | Application fee | .99% to 6.99% | Good credit |
| Merchant Capital Source | Term Loan | \$5,000 - \$500,000 | 6 - 14 Months | Daily | Small fee | 4% to 6% | 575 |
| Merchant Capital Source | Merchant Cash Advance | \$5,000 - \$300,000 | 5 - 12 Months | Daily | Draw fee 1.5% to 3% | Small fee | 500 |

Note that several fintechs such as DealStruck and Raiseworks, which were founded around 2010-12 period have exited this market. Others such as CAN Capital have cut back on lending operations.

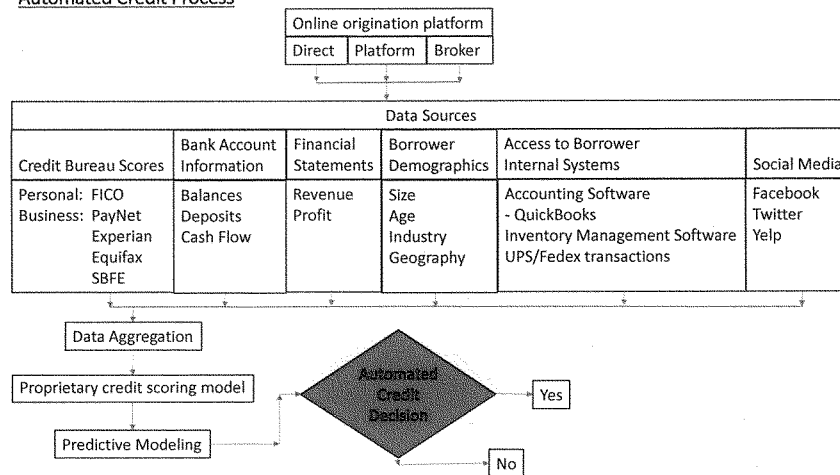
Credit Models and Process

While products are traditional, alternative lenders use non-traditional methods and data sources to grant credit. Data sources include credit bureaus, bank account statements, financial statements, tax returns, borrower demographics, borrower internal data and social media. The non-traditional metrics used by alternative lenders has partially obsoleted the traditional relationship-building process that used to take years to form between small businesses and community banks. Previously, a community banker would spend years forming a relationship with a local small business and understanding what the community thought of that small business. Now, alternative lenders can approximate that process in minutes by looking up the businesses' Yelp review, among other metrics that did not exist even a decade ago. This information is aggregated and run through proprietary credit models to arrive at a decision. This process runs on proprietary software developed by the lender to fit their business process. Many alternative lenders have invested considerable amounts of money to create the software and the credit models. The credit models use empirically derived and statistically sound model development methods to create a rank order of credit risk. Credit approval rates range from the mid 11% to 79% for lenders depending on the security and market segment.

Fintech lenders seek to control the financial data to ensure they are controlling access to their customer. Tech exists to deliver this now. Collection, data entry and spreading of financials are

a low value high cost step. Financial statement spreads are likely not done at the loan officer/senior credit officer level but they are required by bank policy and probably expected by the regulators. Banks often have a flood of renewals/restructures and annual reviews that requires prioritization.

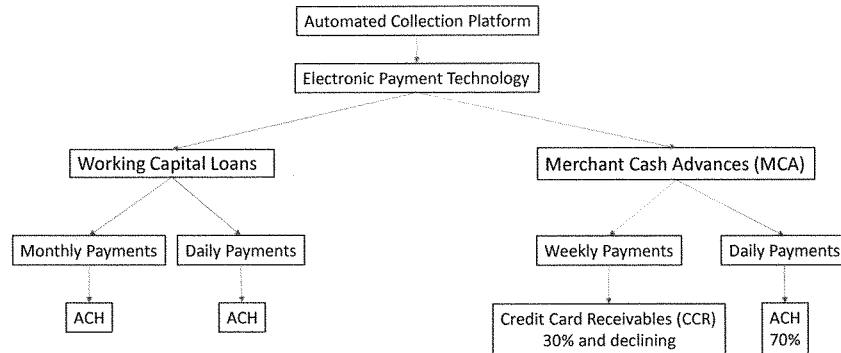
Automated Credit Process



One example of the unique use of data is the bank account information. Lenders link into the borrower's bank account to track cash balance at will. This allows the lender to gain an early warning of inability to pay and to take more aggressive steps earlier. Lenders track credit on a daily basis. Another example of non-traditional data use is Google site visit. This is an online photo of the business. It enables the lender to see the business and gain an understanding of the location and property.

Another non-traditional aspect of marketplace lending is the daily repayment of the loan. In many cases the repayment is debited each day directly from the borrower's checking account via ACH. Daily payment results in a different definition of default. For many lenders, 7 days or more past due becomes severely delinquent and default occurs after 60 days past due. In some cases payment schedules can vary from weekly to more traditional monthly term.

Loan Repayment

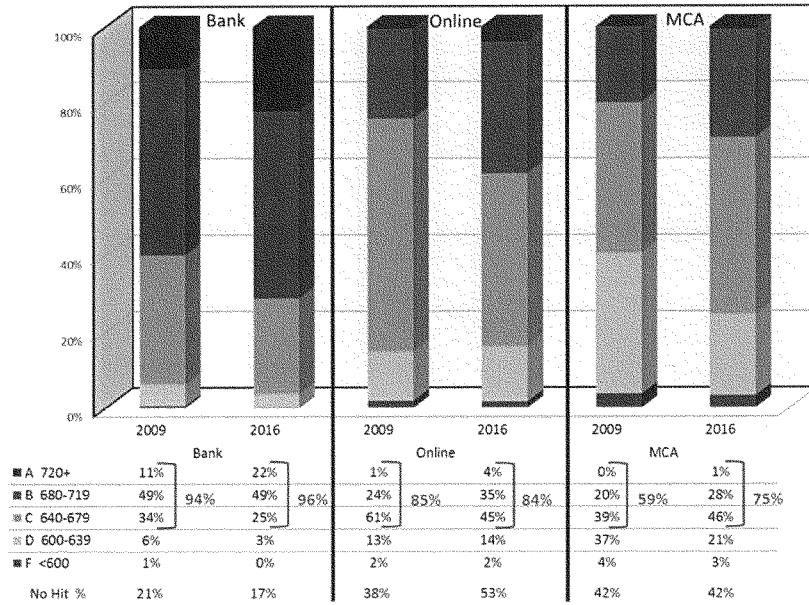


Fintechs have found ways to lower the cost of processing a credit application compared to banks. Some fintechs have lowered this operating cost to under \$500 per application versus banks which incur cost per application as noted above.

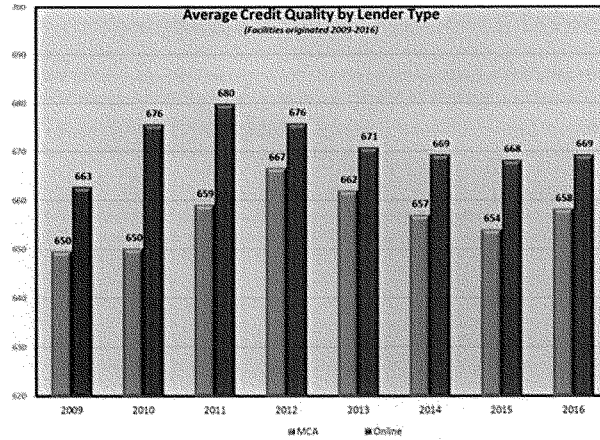
Borrower Credit Quality

PayNet analyzed the portfolios of marketplace lenders to determine the absolute level of credit risk and to determine differentiation by lender type. We found the following key insights into marketplace finance:

1. In 2016, 84% of Online lenders' portfolio quality stands at a score of 640 or higher. In comparison, 96% of banks' portfolio is the same credit quality.
2. Overall credit quality has improved for Online lenders from 663 in 2009 to 669 in 2016.
3. Credit migration shows that in 2009, 25% of Online lender's portfolio stood at 680 or higher; by 2016, the portion of these higher quality borrowers had increased to 38%.
4. Online/direct lenders show an average score of 669 in 2016, which equates to a default rate of approximately 10.5%. In contrast, new Bank originations had an average credit score over 700, which equates to a default rate of approximately 1.1%.
5. Average facility size for online lenders totals approximately \$65,000.
6. Average transaction term of an online loan is approximately 15 months in length. 34% of online loans are in excess of 18 months term which is a large increase from 0% in 2009.
7. 70% of borrowers that use online loans have been in business 10+ years. This compares to 77% for banks.

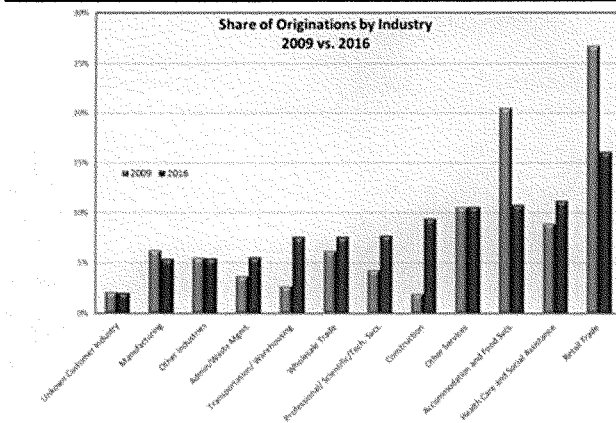


Marketplace lenders appear to overlap with a majority of banks' customers as measured by credit quality. B and C quality borrowers make up 74% of bank's customers and 80% of On-Line lender's customers. Note that calibration of credit models differs by lender type with the result that default rates can differ at the same credit score.



Online lenders are expanding their lending operations to provide credit to small businesses engaged in diverse industry sectors. As the chart Share of Originations by Borrower Industry shows, online loans are used by small businesses in retail, healthcare, accommodation & food, other, construction, professional services, wholesale, transportation, administration, and manufacturing industries.

Share of Originations by Borrower Industry 2009 vs. 2016



Impact of Online Lending on Small Businesses

Question: Does access to credit from online lenders result in improving credit quality for borrowers or do all borrowers deteriorate?

| | Credit Quality | |
|--------------|-------------------|-----------------|
| | Start 1/1/2015 | End 7/1/2017 |
| Improved | | 66% |
| No Change | 100% | 10% |
| Deteriorated | | 24% |

Findings:

- Of 100% of borrowers in 2015,
- 69% migrated to higher quality.
- 24% of borrowers migrated to a lower credit quality.
- 10% were unchanged.

Summary

Post financial crisis of 2009 clearly resulted in disruptions in the credit market for small businesses as traditional sources of credit like community, regional and large banks could no longer profitably supply credit or they were preoccupied with other more pressing issues in their businesses. Partly due to the JOBS Act and partly due to new applications of technology, innovators in the form of fintechs invented new ways to provide credit to small businesses to fill this “credit gap”. Fintechs have faced the challenge of building systems for sourcing borrowers, finding the capital to make loans and building the technology platforms to lower the cost of processing a credit application. Fintechs have excelled at building technology platforms to lower the cost of providing credit applications to small businesses. They still face high costs to find prospective borrowers and they face high costs of capital as a source for their loans. I note that since the dawn of fintech, several have decided to exit this market or they have gone out of business themselves.

It is clear that fintechs have not fully realized the potential they held several years ago when many equity analysts predicted fintech would transplant banks as a primary source of credit to consumers and small businesses. But fintechs have provided three critical benefits to the supply of credit to small businesses: first, they have figured out technology platforms to lower the cost of a credit application; second, they have changed the expectations among small businesses for access to credit working capital, which traditional sources cannot afford to offer at a reasonable cost; third, they are filling the

credit gap faced by small businesses across the credit spectrum and industry sectors. More work must be done by these innovators to improve their business models and I note that many fintechs are themselves small businesses.

Improvements in fintech business models include cheaper sources of capital that can be the source for lower priced loans. Another major improvement necessary for fintechs to become a long term source of credit for small businesses is to lower the cost to acquire their customers who are the prospective business borrowers. Also, many fintechs are addressing the capital and customer acquisition business issues through partnerships with banks. Most importantly, they must continue to work on their business methods to provide transparency, for example the ILPA provides with its SMART Box, on the terms of loan contracts with small businesses. Like any market of suppliers, lenders to small businesses provide varying degrees of information about their product to ensure their loan contracts are fit for the intended purpose. My concern is that fintech, in its early stage of development, could fail as an industry to fill the credit gap. This failure could result from lenders who do not fully inform borrowers on the terms of their loan contracts and in doing so, create the impression that all fintech lending is an untrustworthy source of credit. This could drive away other lenders that are providing better disclosure about the terms of their contracts and seeking to lower the cost of delivering credit to small businesses. In this scenario of market failure, less supply of credit becomes available for small businesses and the credit gap becomes a bigger issue.

APPENDIX: Methods and Sources

*Contract Count rounded to 10,000 increment

Assumptions Made

1. For commercial finance data, the Federal Reserve's Finance Companies estimate of the value of total loan and lease as a given, and then assume that the \$250k and below and \$1 million and below share of loans and leases balance outstanding contract count in the PayNet database—respectively—is representative of national data in each of the loan and lease segments for business lending.
2. For Alternative Lenders, we use the 2016 estimate of balance outstanding from the Ernst and Young report, and then assume that the \$250k and below and \$1 million and below balance outstanding contract count in the PayNet database—respectively—is representative of national data.
3. For Commercial Bank data, the assumption is that the data provided from the FDIC in the latest Quarterly Banking Profile is accurate.

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Testimony Submitted by
Katherine C. Fisher, Partner, Hudson Cook, LLP
On behalf of the
Commercial Finance Coalition
before the
House Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access
October 25, 2017

Thank you for the opportunity to present testimony on behalf of the Commercial Finance Coalition ("CFC"). The CFC is comprised of responsible finance companies that provide needed capital to small businesses through innovative methods. Our members also include select vendors that provide technology services to the small business finance industry.

CFC member companies offer fair and innovative alternatives to bank term loans and have stepped in to provide capital to small businesses when larger, traditional banks stopped providing such financing. CFC member companies primarily offer Merchant Cash Advance ("MCA") factoring products. An MCA allows small businesses to access funds for, as an example, a seasonal inventory surge or to replace an unexpected major equipment failure. CFC members provide financing between \$10,000 and \$500,000 to qualified small businesses.

CFC member companies help meet the needs of American small business entrepreneurs. CFC member companies provide financial flexibility for small business owners who lack the daily capital to expand their businesses or weather difficult financial circumstances. By selling future receivables to MCA companies, these business owners can meet their capital needs, hire new employees, and create jobs in today's economy.

The CFC believes that small businesses should have choices in the financial marketplace. The CFC works to unite responsible finance companies in our efforts to educate Congress, federal and state regulators, and state elected officials about the non-bank commercial finance industry. Small businesses face a gap in credit availability. CFC member companies are trying to close the gap and help spur entrepreneurship so more Americans can own and operate their own businesses.

Small Businesses Need Choices.

Small businesses benefit from having different types of financing available. A business owner who is planning for long-term capital needs may choose to apply for a loan guaranteed by the Small Business

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Page 2

Administration ("SBA"). These SBA loans are relatively low-cost and typically range from \$25,000 to \$5 million. The applicant typically must submit a business plan¹ and the business owner often must use her house as collateral for the loan.² A business owner who has short-term capital needs may choose to apply for a loan from a non-bank lender or apply to sell future receivables to an MCA company. These types of transactions are typically higher-cost and are in smaller dollar amounts. The applicant typically must submit bank statements showing several months of revenue, and the business can receive funds in a matter of days.

Whatever the type of financing a business owner chooses, banks alone are not addressing the needs of small businesses. Other financing sources are finding success because small businesses demand them. This demand shows that they are being underserved by the "traditional" funding sources.

The Landscape of Financing Options Available to Small Businesses

Traditional Lending – Despite their decline in issuance, traditional bank loans remain the primary source of financing for small businesses, in part due to familiarity.³ Banks often form relationships with their small business customers and have been willing to underwrite loans.⁴ The structure of traditional lending tools also has its advantages. Small businesses can carefully compare readily available loan terms against other loans, and the loans involve a defined maximum cost to the business. Traditional loans often involve flexible repayment terms (e.g., 3-10 years), can be obtained for higher-dollar amounts than other financing tools, and are not always secured by collateral. Moreover, guarantees from the SBA provide additional security for banks, enabling more small businesses to access traditional lending.

Nevertheless, traditional lending suffers from certain deficiencies, making it inaccessible or impractical to some small businesses. As a threshold issue, qualifying for a traditional bank loan can be an onerous task for many small businesses. Small businesses often do not have the required audited financial statements or assets that can be pledged as collateral.⁵ The ideal loan applicant would have a lengthy history of

¹ The SBA provides a 37-page guide to help loan applicants prepare a business plan. *How to Write a Business Plan*, U.S. Small Business Administration, available at <https://www.sba.gov/sites/default/files/How%20to%20Write%20a%20Business%20Plan.pdf>.

² See *Loan Fact Sheet*, U.S. Small Business Administration, available at [https://www.sba.gov/sites/default/files/SBA%20Loan%20Fact%20Sheet%20\(San%20Diego%20District\).pdf](https://www.sba.gov/sites/default/files/SBA%20Loan%20Fact%20Sheet%20(San%20Diego%20District).pdf).

³ *2015 Small Business Credit Survey*, Federal Reserve Banks of New York, Atlanta, Cleveland, Philadelphia, St. Louis, Boston, and Richmond, March 2016, available at <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf>.

⁴ Karen Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation* (November 29, 2016), Harvard Business School Entrepreneurial Management Working Paper No. 17-042; Harvard Business School General Management Unit Working Paper No. 17-042, available at SSRN: <https://ssrn.com/abstract=2877201> or <http://dx.doi.org/10.2139/ssrn.2877201>.

⁵ Brainard, Lael, *Community Banks, Small Business Credit, and Online Lending*, Board of Governors of the Federal Reserve System. September 30, 2015, available at <https://www.federalreserve.gov/newsevents/speech/brainard20150930a.htm>.

profitable performance, but the reality is that many small businesses have short histories or a mixed track record of profitability.⁶

The risks associated with traditional lending make it impractical for some small businesses as well. Because loans are absolutely repayable, the assets of the business—and sometimes the business owner's home—are at risk, and default can force a small business into bankruptcy.

Lenders are equally concerned about risk. In an environment where regulators heavily scrutinize banks, lenders are increasingly cautious about extending debt. As a result, banks have increased collateral requirements, reduced the amount available for borrowing, and reduced the pool of small business borrowers deemed creditworthy. Ninety percent of loans under \$100,000 were secured by collateral in 2013, up from 84 percent in 2007.⁷ In addition to the regulatory risks, banks may be less willing to issue smaller business loans, because the underwriting costs for banks to scrutinize a potential borrower's financial records and business plan are about the same regardless of whether the loan application is for \$2 million or \$20,000.⁸

Even qualified borrowers have difficulty finding willing lenders in a reasonable timeframe. According to a survey conducted by seven Federal Reserve banks, the average small business owner spends 24 to 72 hours talking to lenders, filling out loan applications, and submitting documentation.⁹ This survey further suggests that some borrowers were willing to pay a higher price in exchange for an easy application process, a quick decision, and rapid availability of funds.¹⁰

“Fintech” Lending – Fintech lending includes non-traditional lending that directly addresses some concerns of small businesses by providing faster access to capital than traditional lending. Compared to the lengthy process of finding a traditional loan, business owners can quickly shop lenders on the internet, apply for a loan, and receive a decision in as little as an hour.¹¹ Technology has allowed lenders to automate the lending process, leading to a less burdensome application process. Algorithms allow fintech lenders to render rapid decisions on applications, often considering information from a wide range of sources that are not typically involved in bank underwriting of loans (e.g., data on online banking, accounting, bookkeeping, credit cards, and social media).¹² The existence of fintech lenders provides small businesses with the ability to quickly obtain capital needed for immediate operations.

Non-traditional loans are not without their disadvantages. For instance, some borrowers may not be as familiar with the lending products. Additionally, although some small businesses reported a willingness

⁶ *Id.*

⁷ Wiersch, Ann Marie & Scott Shane, *Why Small Business Lending Isn't What It Used to Be* (August 14, 2013), Economic Commentary (Research Department of the Federal Reserve Bank of Cleveland).

⁸ Stacy Crowley, *Online Lenders Offer a Faster Lifeline for Small Businesses*, N.Y. Times, April 8, 2015.

⁹ *Supra* note 1.

¹⁰ *Id.*

¹¹ Cowley, *supra* note 6.

¹² Brainard, *supra* note 3.

to pay a higher price in exchange for the convenience of alternative products, one report suggests that the average annual cost of borrowing tends to be higher than the costs associated with traditional bank products.¹³ Small business borrowers may not fully understand the terms of the loan, and much like traditional loans, default can place the entire business at risk.¹⁴

Factoring – Factoring is the purchase of invoices at a discount. Factoring has been used by businesses to obtain financing for hundreds (perhaps thousands) of years.¹⁵ In a factoring transaction, a small business that sells goods and services to a customer can then sell the invoice from the sale to a finance company called a “factor.” The invoice is typically payable within 30 to 60 days. The factor pays upfront and buys the invoice at a discount, allowing the small business to obtain the cash quickly. The factor takes the credit risk that the small business’s customer cannot or will not pay the invoice.

Merchant Cash Advance – MCA is a specific form of factoring. It involves a business selling a fixed portion of its future receipts to an MCA company in exchange for money upfront.¹⁶ Under these agreements, the business does not promise—and is not required—to repay the MCA company.¹⁷ Instead the business delivers the receipts that it sold to the MCA company as the business earns those receipts.¹⁸ The receipts are purchased by the MCA company at a discount to cover the MCA company’s expenses and to compensate the MCA company for assuming risk. The risks taken by the MCA company are significant. If the business fails to earn revenue, the MCA company is not owed anything under the agreement, so long as the business has not breached the agreement.¹⁹

For example, if an MCA company purchases \$10,000 of a small business’s future revenue and agrees to receive 10% of the small business’s future revenue until the \$10,000 is received, the transaction would be completed whenever the small business succeeded in getting \$100,000 of cumulative revenue. This milestone could be achieved in a month, a year, or never.

The Advantages of MCA – MCA has many advantages for small businesses. MCA injects funds into a business without the business incurring debt, as the agreements do not contain an obligation of repayment.²⁰ MCA has transparent costs for the small business: the MCA company will receive the amount of revenue that it purchased from the business. The incentives of the MCA company and the business are aligned because the MCA company’s compensation is contingent on the continued success

¹³ *Id.*

¹⁴ *Id.*

¹⁵ David B. Tatge, et al., *American Factoring Law* 4-8 (2009).

¹⁶ See, e.g., *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 57 N.Y.S.3d 625 (Sup. Ct. N.Y., Westchester County, May 4, 2017).

¹⁷ See *IBIS Capital Group, LLC v. Four Paws Orlando LLC*, 2017 NY Slip Op 30477(U) (Sup. Ct. N.Y., Nassau County, March 10, 2017) (discussing factors used to distinguish between loans and merchant cash advance agreements).

¹⁸ See *K9 Bytes, Inc.*, 57 N.Y.S.3d at 632-34.

¹⁹ See *id.*

²⁰ See *id.*

of the business.²¹ Addressing a key concern with traditional financing, MCA companies quickly fund businesses by offering efficient and timely underwriting.²² Additionally, in MCA, the business owner does not enter into a partnership or give up control of the business.

MCA, however, is not suitable for businesses at every stage of development. MCA depends on the future revenue of the business and is generally provided to companies that already have a proven source of revenue. Startups that do not expect substantial revenue for an extended time would not be ideal candidates for MCA.

Equity and Partnership – The Subcommittee focuses on fintech financing and online lending, but equity financing provides small businesses another avenue for funding. Small businesses can receive funding by entering into partnership agreements or by selling a portion of the company to investors. These agreements have the advantage of providing funding for the business without the business incurring debt. Equity funding, however, is not readily available for all businesses, with venture and angel capital making up less than 2% of small business financing in 2016.²³ Also, even when equity funding is available, the business owner must limit potential gains by relinquishing a share of the business. Moreover, depending on the agreement between the parties, the business owner may risk giving up control of the business itself.

Existing Regulation is Sufficient to Protect Small Businesses

The MCA and commercial lending spaces are sufficiently regulated by existing federal and state laws and regulations. Both MCA companies and commercial lenders must comply with laws and regulations affecting nearly every aspect of their transactions, from marketing and underwriting through servicing and collection. Even if they comply with every applicable law and regulation, small business financiers must also be wary of the Federal Trade Commission's ("FTC's") powerful authority to prevent unfair or deceptive acts or practices.

For example, at the federal level, the Fair Credit Reporting Act ("FCRA") and its implementing Regulation V, which govern entities in the consumer reporting industry, including consumer reporting agencies, users of consumer reports, and furnishers of consumer information, apply to business-purpose transactions. The FCRA generally protects individuals, regardless of the purpose of the transaction, including by requiring a financier to have a permissible purpose to pull a consumer report for a sole proprietor or for an individual guarantor of a business's transaction.²⁴ This is particularly relevant in the

²¹ See *id.*

²² *Opportunities and Challenges in Online Marketplace Lending*, p. 13, United States Department of the Treasury (May 10, 2016), available at https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.

²³ *Frequently Asked Questions About Small Business Finance*, U.S. Small Business Administration (July 2016), available at https://www.sba.gov/sites/default/files/Finance-FAQ-2016_WEB.pdf.

²⁴ See 15 U.S.C. § 1681a(c) (defining "consumer" as an individual).

world of small business finance, where the business is often organized as a sole proprietorship, or an individual owner will serve as guarantor in the event of default by the business. Additionally, the FCRA requires a user to provide notice to an individual if it takes adverse action on the basis of information contained in a consumer report on the individual.²⁵

Additionally, the Telephone Consumer Protection Act²⁶ and the CAN-SPAM Act²⁷ restrict certain telephone and email communications and apply to business-purpose transactions.

Moreover, Section 5(a) of the Federal Trade Commission Act gives the FTC broad enforcement authority to prevent unfair or deceptive acts or practices (“UDAPs”) over a wide range of entities, including MCA companies and commercial lenders.²⁸ The FTC wielded its authority to protect small businesses as recently as 2014, when it entered into a consent order with a company that leased payment processing devices to small businesses.²⁹ The authority to prevent UDAPs is an extremely powerful tool in the FTC’s arsenal, giving it the ability to target entities that may be technically complying with the law but are engaged in otherwise harmful practices.

Commercial lenders also must comply with the Equal Credit Opportunity Act (“ECOA”) and its implementing Regulation B. ECOA and Regulation B prohibit discrimination against protected classes of people in the extension of credit, apply to business credit, and provide protections specifically for business borrowers.³⁰

Finally, many states require a license to make a loan to a business, limit the interest rates lenders may charge to business borrowers, or both.³¹ With a licensing scheme comes state regulator supervision. States that regulate lending also typically limit the terms of loans, require disclosures in loan documents, and limit the fees that creditors may impose. Most state laws regulating lending apply to loans with smaller dollar values, exactly the types of loans upon which small businesses rely.

²⁵ 15 U.S.C. § 1681m(a).

²⁶ 47 U.S.C. § 227.

²⁷ 15 U.S.C. §§ 7701 *et seq.*

²⁸ 15 U.S.C. § 45(a).

²⁹ *Federal Trade Commission v. Merchant Services Direct, LLC*, Case #: 2:13-cv-00279-TOR (E.D. Wa. 2014), available at <https://www.ftc.gov/system/files/documents/cases/141125merchantstip.pdf>; see also, “Press Release: FTC Charges Marketers with Deceiving Small Businesses into Buying Credit/Debit Card Processing Services and Equipment” (July 30, 2013), available at <https://www.ftc.gov/news-events/press-releases/2013/07/ftc-charges-marketers-deceiving-small-businesses-buying>.

³⁰ 12 C.F.R. § 1002.9(a)(3). Protected classes include: Race, color, religion, national origin, sex, marital status, age, exercising rights under the Consumer Financial Protection Act, and deriving income (some or all) from a public assistance program. See 12 C.F.R. § 1002.1(b).

³¹ See, e.g., Or. Rev. Stat. § 82.010(3)(a) (imposing a specific interest rate limit on business-purpose loans); Cal. Fin. Code §§ 22009(a), 22100(a) (requiring a license to make business-purpose loans); Ala. Code §§ 5-18-4(a), 5-19-3(a), 5-18-15(a) (requiring a license to make loans of any purpose, and limiting the interest rates that a licensee may charge for loans of any purpose).

House Small Business Committee

Subcommittee on Economic Growth, Tax and Capital Access

“Financing Through Fintech: Online Lending’s Role in Improving Small Business Capital Access.”

October 26, 2017

Testimony by Trevor Dryer

CEO, Mirador Financial

Introduction

Chairman Brat and Ranking Member Evans, thank you for the opportunity to testify today on the role fintech plays in helping small business access capital. It is an honor to be here sharing the insights and experience we have accumulated working in this important space.

My name is Trevor Dryer and I am the CEO of Mirador, a small business of 24 employees, headquartered in Portland, Oregon. In the regulated banking space, Mirador is a 3rd party service provider and is treated as such by bank examiners. The cloud-based Mirador platform is a “white label” technology solution marketed under a bank, credit union or CDFI’s brand, enabling them to profitably originate small business loans as low as \$2,500, and offer competitive rates by using technology to facilitate some of the more labor-intensive parts of the loan-making process, creating a fast and easy experience for the small business borrower.

Mirador is not a lender. Our technology supports each of the following services for customers who are lending: customer acquisition, application (both online and in branch), loan origination, underwriting, pre-screening or “decisioning,” and decline referrals. As a front-end solution with extensive back-end functionality, all aspects of our platform focus on improving the engagement and experience between borrower and lender. Our technology supports: commercial term loans, SBA backed loans, working capital/lines of credit, commercial real estate loans, and small dollar loans.

Our platform is highly-customizable and reflects the existing credit criteria established by our customers. Our role in the loan-making process provides us with unfettered sightlines into current small business lending trends including types of businesses looking for capital, geographic distribution of a sample size of small business loans, credit availability, and the risk appetite for different types of institutions. I can you from my professional work and my personal experience, access to affordable capital remains a major hurdle for small businesses around the United States.

Our customers are regional, mid-sized and community banks, credit unions, CDFI’s and other mission-based lenders. Their customers are the small businessmen and women in the communities

they service who are seeking loans for as little as a couple thousand dollars, up to several hundred thousand dollars or more.

Mirador is dedicated to the proposition that regulated financial services companies want to serve small businesses in their communities, and are equipped to do so at competitive rates with robust consumer protections. Due to a number of factors including regulatory costs, small business loans below a certain dollar amount are unprofitable for regulated financial services entities. However, with the help of Mirador's technology, our customers make smaller loans profitable once again, increase the profitability for larger loans, improve the customer experience for borrowers, and utilize supplemental underwriting, techniques and data sources helping more lenders "get to yes" for qualified small businesses.

Borrower Experience

When a lender partners with Mirador, they license our platform. Again, the platform is highly customizable. We import the lender's credit criteria and integrate the platform into the bank's preferred origination channels, whether in-branch, online or mobile.

Once integrated, applicants seeking a business loan apply through the bank portal either directly on the bank's website, or working with an employee who takes the application information in-branch. Though routed onto the Mirador rails, the borrower's experience remains on the bank's website with the "Powered By Mirador" phrase and logo at the bottom of the screen. All of the branding, marketing and compliance disclosures are determined by the bank and bank regulators.

Applicants will follow simple steps to fill-in their information and, with their affirmative consent, Mirador technology completes a credit memo by pulling additional data from public records, credit bureaus, accounting software, bank accounts and the IRS. The credit memo is transmitted to a bank's loan officer with an indication of credit-worthiness—again, based on the credit tolerances the bank has provided. The indication is communicated through a GREEN-YELLOW-RED system—green essentially indicating an approval, red a denial, and yellow a conditional approval pending the acquisition of more applicant information.

The value to the bank is that, up to this point in the lending process, a bank employee has not spent time compiling documents, calling the applicant and calling them again to get more information to compile a complete credit memo. Our lenders report as much as a 69% reduction in time spent per application, and a savings of roughly \$1550 per loan origination. Additionally, our lenders see roughly a 60% application completion rate, due to the significantly easier, less labor-intensive application process. Several lenders have reported seeing a 40-50% increase in loan applications after implementing Mirador's technology due to this higher application completion rate, and also being able to attract borrowers disinclined to go through a cumbersome application process.

The value for the borrower is spending less than 10 minutes compiling an application, as opposed to the average time of 30 hours.

According to the Joint Small Business Credit Survey Report of 2016¹, borrowers overwhelmingly state “difficulty with the application process” and “long wait for credit decision” as the principle reasons for dissatisfaction with a borrowing experience, far outweighing rates or repayment terms. Mirador works hard to efficiently use the borrower’s time.

Our adaptive application experience changes and presents questions based on the borrower’s risk. For example, as we collect information we may seamlessly route a borrower into a SBA process if too risky for a conventional term loan. We also use a unique algorithm in compiling the underwriting information for our lenders and to match a borrower with the lender most likely to approve a loan. If the borrower is generally too risky for our partner banks or credit unions, our technology seamlessly routes, with the borrower’s consent, the application to a non-profit CDFI. Thanks to this routing ability, the borrower does not need to start the application process over with the new lender, thus saving significant time. This is also a unique way to increase awareness of low-cost lenders, such as CDFIs, that traditionally do not engage in marketing activities.

Mirador also provides the bank with deeper analytics about their application traffic, loan performance and customer mix. But the real value is getting more small business loans into the hands of creditworthy applicants. Aside from the licensing fee, we are paid for every completed credit memo regardless of the lending decision.

In our mission to provide more small businesses access to capital through traditional, regulated entities, we are working with various groups having a small business customer base. By growing our client base, we envision a neural network of partners, borrowers and lenders passing along customers to ensure that any small business can seamlessly access affordable credit from a traditional, regulated institution without going through the time and trouble of starting the application process over again from the start. As our network continues to grow and the number of small business customers increases, the technology provided by Mirador will only improve.

What We’re Seeing

Often the owner of a small business is the CEO, CFO, CIO, CTO and likely the person handling all of the day-to-day work required to keep the business running. In other words, handling the business’ finances is just one more task for the business owner and often is the task left to the end of the day during non-business hours. In fact, we have heard reports that less than 10% of small businesses have a CFO or someone looking after their finances full-time.

A study in 2015 by the Cleveland Fed found that the #1 complaint of small business borrowers was that the application process was too cumbersome, and the #2 complaint was that the process

¹ <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf>

too long². Also, the typical hours of operation for a bank branch overlap with the hours the business owner is usually trying to run their business. As such, a time consuming application process becomes extremely difficult.

A 2014 Federal Reserve study calculated the amount of time the average small business owner commits to applying for a small business loan. Whether the loan is \$1000 or \$1 million dollars, on average it will take over 24 hours to research, fill out the applications, gather documents and submit the necessary information needed by the bank for underwriting³. That's 24 hours just to get the process moving forward. There is still the approval process, underwriting and information verification handled by the bank.

It can take weeks for the small business owner to see capital, if approved. I emphasize "if" because underwriting for small businesses is tricky, time consuming and expensive. In fact, it will cost a bank just as much to underwrite a \$100,000 small business loan as it does a \$1 million loan, a cost which the Oliver Wyman consulting firm found to be between \$1600 and \$3200 per loan application, regardless of loan size⁴. This leaves very little incentive for the banks to offer small-dollar loans.

From this narrative, it is also easy to see why so many small businesses turn to online lending for their capital needs. In fact, 21% of small business loans are currently going to higher-priced, non-bank lenders, and this number is growing⁵. The online lending community provides 24 hours access, near-instant approvals, and quick turnaround on capital available in smaller cash amounts. For so many small businesses, this is the only logical and available—albiet often expensive—option to meet their capital needs.

Mirador Financial was created with these small business pain points in mind, but also with the understanding that capital offered by traditional lenders is often less expensive and carries better terms for the borrowers.

Mirador currently works with 20 banks and credit union partners and 4 CDFIs and our network continues to grow. We believe our technology brings the necessary conveniences of online lending to the traditional financial institution space, offering one more option for the small business owner struggling to keep up with their work and make ends meet. To date, we have helped offer over \$600 million in loans to over 4,200 customers. These loans range from \$1000 to \$9.75 million dollars (a SBA 504 loan in a high-priced real estate market) with an average loan size of \$123,000, both non-traditional products like merchant cash advance to SBA 7(a) loans. We are crossing the gap between small business, small dollar lending and traditional commercial lending.

² <https://www.clevelandfed.org/community-development/small-business/about-the-joint-small-business-credit-survey/2015-joint-small-business-credit-survey.aspx>

³ <https://www.newyorkfed.org/medialibrary/media/smallbusiness/SBCS-2014-Report.pdf>

⁴ https://qedinvestors.com/wp-content/uploads/2015/10/The-Brave-100-The-Battle-for-Supremacy-in-Small-Business-Lending_vf.pdf

⁵ <https://www.newyorkfed.org/smallbusiness/small-business-credit-survey-employer-firms-2016>

While innovation is clearly improving access to capital for small businesses, a number of issues still negatively impact this market and place the borrower at a disadvantage.

To that end, I proffer three policy recommendations which can unlock additional capital for small businesses by further removing pain points for borrowers (and lenders).

Encourage the IRS to automate the 4506T process for a third party to obtain a tax transcript.

Congressman Patrick McHenry (R-NC) and Earl Blumenauer (D-OR), as well as the ranking member of this committee Congresswoman Nydia Velázquez (D-NY), introduced H.R. 3860, the IRS Data Verification Modernization Act of 2017 requiring the IRS to automate the Income Verification Express Services Process by creating an Application Programming Interface (API), which would reduce paperwork and the waiting period that currently burdens lenders and borrowers alike.

The current process requires a lender to submit (often via fax machine) a 4506-T form to the IRS, requesting a tax transcript which is then used to satisfy income verification requirements in the underwriting process. According to the IRS, the lender will receive a response to the request in 2 days or less. However, the typical experience for the lending community is far longer than 2 days. Forms are faxed back and forth and with some routinely returned for corrections based on clerical errors. In our experience, the 4506-T process averages around a week per request, and longer if the form is returned due to an error. In terms of the overall application process for the small business borrower, this delay is a significant factor in the decision to abandon the loan process and instead seek credit through an alternative source.

The McHenry bill would simply require the IRS to move from a paper-based, fax system to a secure API. Only those third parties authorized by the IRS to pull transcripts under the current vetting process would be able to take advantage of the API. In addition, since a fee is charged “per pull”, the IRS could simply increase this fee to cover the cost of converting to an API.

Provide Community Reinvestment Act (CRA) consideration for referrals to Community Development Financial Institutions (CDFIs) and other covered lenders.

Regulated banks frequently partner with CDFIs in order to satisfy CRA obligations with their regulators. Currently, banks obtain CRA consideration for providing capital investments, offering technical assistance and through collaboration with a CDFI on lending. However, banks do not receive CRA consideration from referring borrowers to these same CDFIs when these loans are too risky for the bank to underwrite.

Our CDFI partners are seeing a rise in refinancing in the small business lending space. When the small business faces an immediate need for capital, and the traditional, regulated bank’s process is too slow, those businesses frequently turn to alternative lenders where terms and interest rates are unfavorable. Oftentimes speed outweighs cost-of-capital when the alternative means missing op-

portunities to expand our just keeping the lights on and the doors open. When the urgency is gone, these businesses are left with high interest debt and payments that cut deeply into revenue. In one of many recent examples provided by a partner CDFI, a refinanced loan saved a small business over \$6300 per month in payments. That \$6300 a month is another employee or a lease payment on new space for the business. On average, one of our CDFI partners reports saving small business borrowers an average of \$3900 per month on the non-bank loans they refinance by extending the repayment term and lending at a much lower APR (typically no higher than 13%).

Given the economic development mission of CDFIs to support small businesses, a successful referral from a bank is something the regulators should incentivize. In collaboration with the NYBDC, we identified an easy and cost effective way to encourage these referrals is through providing CRA consideration. The more options provided to the small business borrower with minimal additional work, the better those businesses are served and the greater impact on the overall economy.

Allow credit reports to transfer with referral loan applications and prohibit credit bureaus from requiring a new inquiry for each new lender.

Most individuals know that credit inquiries affect their credit score. Unfortunately, when applying for a loan, numerous inquiries occur from the various lenders considering the borrower's request, even though the borrower is seeking a single loan. The more inquiries, the greater impact on a credit score and, as credit scores lower the cost of capital increases and becomes more difficult to obtain.

When a small business applies for a loan, they expect the lender to pull a credit report. However, if the lender is unable to approve the loan but can provide a referral to another lender, it is reasonable to expect the credit report to transfer with the application. Unfortunately, the credit bureaus do not allow the reports to transfer and the small business experiences another inquiry on their credit for the same information already obtained for the application that was denied. This is an unnecessary added cost to the application and an unreasonable penalty to the small business.

Unless the credit bureaus willingly change this practice of requiring a new credit report when a loan application is transferred from one institution to another, a statutory requirement should be considered.

Finally, I encourage this committee to continue efforts directed at modernizing and simplifying the loan process through the SBA. The SBA remains a vital source of capital for small businesses, particularly newer businesses and startups. However, the process and technology are cumbersome and keep the SBA from realizing its full potential as a guarantor. Upgrades to their systems must continue or the SBA risks losing its pipeline to online lenders and other fintech players.

SBAOne and SBALine are the flagship programs offered by SBA to improve the borrower experience and previous SBA Administrator Contreras-Sweet and current Administrator McMahon deserve credit for prioritizing modernization in these areas. SBA staff are working incredibly hard—we know them and we speak to them often—but need to overcome imbedded constraints to really modernize these services.

The private sector, including Mirador, has developed world-class matching technology ensuring that borrowers can be considered by a lender under the most appropriate terms and conditions. If the SBA employed this technology, I am confident that it would enable SBA products to reach more borrowers. SBA should be encouraged to look to the private sector for technology solutions, and to apply such solutions to improve efficiently and the overall borrower and lender experience in SBAOne and Linc. Speaking purely on behalf of my company and our customers, it is in our best interest for the SBA to obtain the best available technology.

Once again, thank you so much for this incredible opportunity. As I am sure everyone on this committee knows, small business is the backbone of our economy. These job creators serve the greater good in their local communities and the entire US economy. We must do everything possible to ensure they continue to grow and thrive, creating jobs and opportunity for Americans.



Mirador Financial, Inc.
317 SW Alder Suite 200 / Portland, OR 97204

November 15, 2017

The Honorable Steve Chabot, Chairman
The Honorable Nydia Velazquez, Ranking Member

2361 Rayburn House Office Building
House Small Business Committee
US House of Representatives
Washington, DC 20515

Dear Chairman Chabot and Ranking Member Velazquez:

Thank you for your interest in my testimony at a recent House Small Business Subcommittee on Economic Growth, Tax and Capital Access hearing entitled "Financing Through Fintech: Online Lending's Role in Improving Small Business Capital Access". I am happy to provide additional information in response to your questions submitted for the record.

1. **Mr. Dryer, you recommend that Congress and the regulators take action to facilitate referrals. I'm curious, what are some of the reasons why referrals don't happen currently, en masse? Is it safe to assume it is not due to limitations of technology?**

Technology is not a limitation in facilitating referrals. In fact, technology provides a seamless process for a small business loan application to transfer, upon denial, from a regulated institution to another entity able to make the loan. However, while technology makes the process seemingly simple, without an incentive for the banks to make these referrals, the existing industry practice of simply "moving on" to the next application once their application is denied will continue. While CDFIs and mission-based lenders can and do go out of their way to encourage referrals, the underwriters making the decisions are not the same individuals who are coordinating with the non-profit community lenders. Regulated banks value their relationships with CDFIs and other mission-based lenders because these partnerships bring value to the banks in the form of Community Reinvestment Act (CRA) credit. Currently,

federal regulators provide CRA credit to the banks for direct investments to CDFI loan funds as well as for technical assistance offered by the bank to the CDFI. Providing an additional option for banks to obtain CRA credit through their CDFI partnerships by acknowledging the value of a referral can provide the incentive necessary to further facilitate referrals using technology to seamlessly transfer the small business' application from one institution to another with the ultimate goal of funding the loan at a reasonable rate with fair terms.

I recommend that Congress enact legislation which would require that banks update their CRA approach to facilitate referrals. I believe this could be easily accomplished by directing the functional regulators to give qualified referring entities credit under either the lending test or investment test if they make a referral to another qualified institution and that loan is then funded.

2. Is there any prohibition against referrals or is the basis of your recommendation simply to find a way to incentivize lenders to refer their declines?

As long as the small business provides affirmative consent to transfer their application from one lender to another, nothing prohibits that referral from taking place. However, we have heard anecdotally that banks have, traditionally, been unenthusiastic about referring because of the fear that a small business will take their entire relationship away from the bank who denies and move it to the bank that approves. If the denying bank can play a positive role in finding access to credit for a customer, even if the customer is directed outside of the denying bank, this concern may be mitigated. Providing CRA credit incentives a denying bank to play this role. Conversely, without providing incentives, most banks will continue operating under the status quo.

3. Mr. Dryer, can you identify factors that have contributed to making small(er) dollar business loans unprofitable?

Setting aside all of the arguments surrounding the level of regulation on community banks and financial institutions, the simple fact is that small dollar, small business loans costs more to process than a regulated financial institution can recoup from repayment. Hence, small dollar loans have become a net loss for many banks. Underwriting is an expensive and time consuming process, and for most loans it is a process that helps mitigate the risk in the lending. However, the man hours needed to underwrite a \$5000 small business loan should not be the same as the time to compile a loan file for a \$1 million real estate loan. Without embracing new technologies to streamline and shorten

the process for these smaller loans, regulated institutions cannot compete in the existing small dollar, small business loan market, which is unfortunate given their ability to offer lower rates and better terms. Other factors involve reaching the customer, effectuating application completions and providing the necessary speed in the time from application to funding to keep up with other non-bank lenders.

I hope my responses to your questions provide useful information in your efforts to examine small business access to capital and the use of online lending. Please feel free to contact me should you need additional information. I am happy to be a resource to the committee as you continue evaluating this important market.

Sincerely,

A handwritten signature in black ink, appearing to read "Trevor Dryer". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Trevor Dryer
CEO and Co-Founder



Online Lending Can Address the Small Business Credit Gap

While big corporations and public stock offerings get the media headlines, it's small and medium sized businesses that serve as the engines powering a healthy global economy. Although small business owners in different markets around the world have varying challenges to overcome, they often face the exact same problem: challenges accessing the capital they need to grow.

This challenge has resulted in a global small business financing gap, estimated by the International Finance Corporation at \$2.1-\$2.6 trillion. That's trillion with a T. Even more striking, there are an estimated 200 to 245 million formal and informal businesses globally that either have never taken out a loan or have a loan but consider it insufficient to meet their financing needs. That's both a massive problem and market opportunity for new innovative technologies to help address.

In developed markets like the U.S., accessing capital can be a challenge for many small businesses. While this challenge cannot be solved overnight, the online small business lending platforms that we represent are working hard to step in to fill the void, seamlessly delivering credit options to a range of small business owners who are seeking the capital they need to succeed.

For many small business owners, opportunities may arise and they need to secure capital quickly to take advantage of that fleeting opportunity. Frequently, they need to place an order for equipment today or hire a worker tomorrow. And our economy can't afford to have these new and small businesses waiting for capital and missing out on the chance to grow and thrive. Online small business lenders meet small business borrowers' need for speed and convenience. Applications can be made online and credit decisions completed in one or two days or even in a matter of hours. Disbursement of the funds to the borrower is frequently made in similar time frames. Moving from an application to disbursement of funds quickly grants small businesses the flexibility to take advantage of important opportunities.

It should come as no surprise that small business owners are thrilled to have these new online borrowing options. Four leading trades – Electronic Transactions Association, Innovative Lending Platform Association, the Marketplace Lending Association, and the Small Business Finance Association – commissioned a comprehensive survey of U.S. small business owners from Edelman Intelligence. The survey found that a large majority (70%) of small business owners believe there are more credit options today when compared to five years ago, and 97% of those feel that the growing number of financing options is a good thing. The survey found that the top reasons small business owners are seeking out loans from online small business lending

platforms are to expand their location, manage cash flow and purchase equipment. All three of those uses are directly linked to economic growth.

When a small business owner borrows to expand to a new location or purchase new inventory, the economy grows, workers are hired, and our communities flourish. The Kauffman foundation has found that even in the depths of the U.S. financial crisis, between 2006 to 2009, young and small firms (fewer than five years old and with less than twenty employees) remained a positive source of net employment growth (8.6 percent), whereas older and larger firms shed many more jobs than they created.

In short, online small business lending is working for the borrower and for the broader economy. The Edelman survey also found that levels of satisfaction among small business owners who borrow from online small business lenders are very high; those who previously used online small business lenders are significantly more likely to take out another loan with an online lender than those who used traditional lenders (98% vs. 60%).

As policy-makers in Washington and around the globe consider the profound shifts in our economy and the migration to digital financing options, there are a number of policy choices that can help promote the health of small businesses and new business formation. Federal and state regulatory structures should strive to be flexible and dynamic to promote the healthy competition in financial services that is only possible when online small business lending models like ours are welcomed.

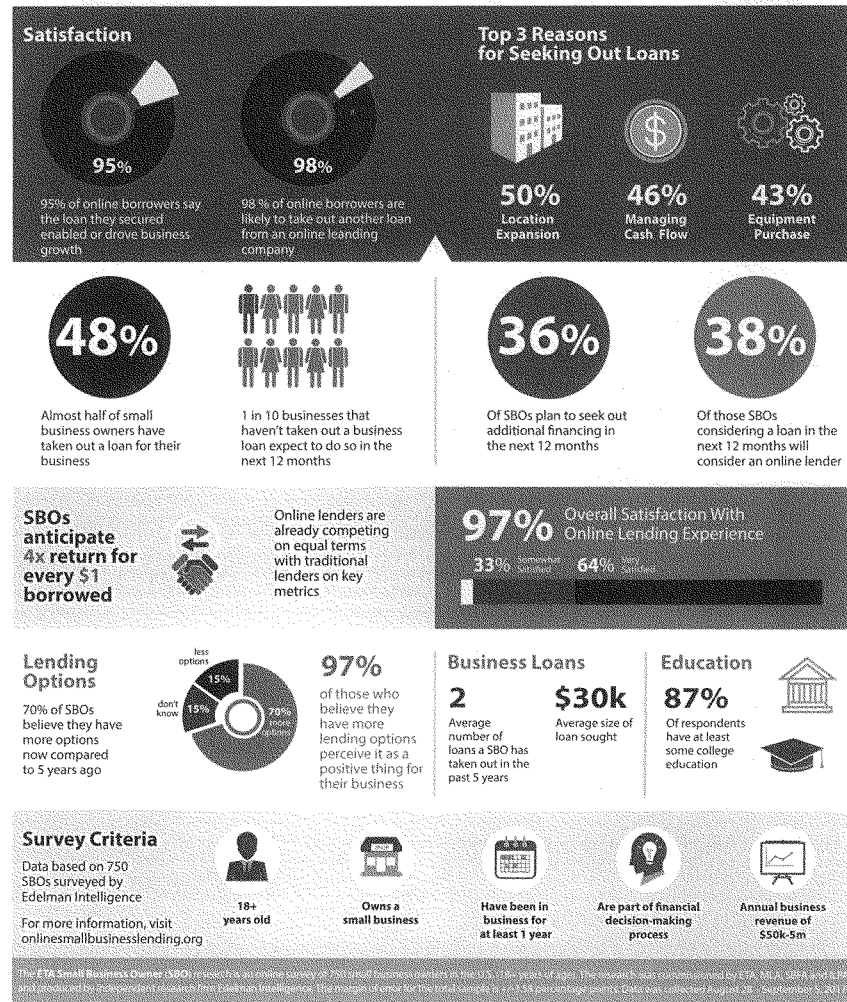
With the right policies in place, online small business lending platforms – at times operating in partnership with traditional financial institutions – can start to narrow the global small business credit gap.

Presented by:

*Electronic Transactions Association
Innovative Lending Platform Association
Marketplace Lending Association
Small Business Finance Association*

Survey on Online Small Business Lending

Presented by: **ETA**
ELECTRONIC TRANSACTIONS ASSOCIATION
MLA MARKETPLACE
LENDING ASSOCIATION
SBFA MEMBER
Innovative Lending Platform Association



*Usman Ahmed, Thorsten Beck,
Christine McDaniel, and Simon Schropp*

Filling the Gap

How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises

Small- and medium-sized enterprises (SMEs) account for more than one-half of the world's GDP and employ two-thirds of the global workforce.¹ The number one barrier to growth faced by SMEs around the globe is access to financing.² This is not a new issue, as the onerous information, administration, and collateral requirements associated with traditional loans have inhibited SMEs from seeking or securing financing.

The 2008 financial crisis only exacerbated the problem, as many local retail banks (often the primary providers of SME financing) closed their doors and the appetite for taking on high-risk SME loans was quelled. The International Finance Corporation estimated that SMEs faced a \$2 trillion global credit gap in 2010.³

Online business lending may be stepping in to fill this gap by resolving many of the barriers associated with traditional SME financing. It does so by leveraging new business methods and targeted data analysis generated from past transactions, social interaction data, and back-end financial data (taxes, receivables, etc.). Big data analysis enables modern lenders to better understand the credit risk of an individual SME and provide it with targeted funding in a timely manner with a flexible repayment schedule, and it often can do so without requiring collateral.

Online business lending comprises a number of different models. This paper analyzes data from PayPal Inc., a company best known for its global online payment system, and from Kiva, a crowdsourcing platform. Our objective is to understand how technology is impacting SMEs' ability to access financing. PayPal Working Capital (PPWC) launched in late 2013; it is a product that enables SMEs to apply for and obtain short-term credit. PayPal Working Capital loans are fund-

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Usman Ahmed, Thorsten Beck, Christine McDaniel, and Simon Schropp

ed by a state-chartered industrial bank. In October 2015, PayPal announced that the product had reached \$1 billion in funding to entrepreneurs in the U.S., UK, and EU.⁴ The dataset we analyze here consists of 60,000 PPWC loans disbursed to more than 18,000 SME owners in the United States between October 2014 and March 2015. Kiva, which was launched in 2005, enables people to lend money to entrepreneurs through an easy-to-use Internet platform. A marketplace that connects lenders and borrowers, Kiva has loaned nearly \$800 million since it was launched, and the company boasts a community of more than 1 million lenders and nearly 1.8 million borrowers.⁵ One of Kiva's cofounders is a former PayPal employee, and Kiva maintains a close partnership with PayPal. The Kiva dataset we analyze comes from Kiva Zip, a program through which lenders make loans with zero-percent interest directly to borrowers in the U.S.⁶

Key findings from our analysis of these two online business lending services include the following:

- Online business loans seem to have stepped in to fill the SME funding gap left in the wake of the 2008 financial crisis. A high proportion of PPWC loans are disbursed in zip codes that have experienced a relatively steep decline in the number of traditional retail banks, nearly 25 percent of PPWC loans were disbursed in the 3 percent of counties that have lost ten or more banks since the 2008 financial crisis.
- Young and minority-owned businesses with low and moderate income benefit particularly from online business loans. Nearly 35 percent of PPWC loans go to low- and moderate-income businesses, compared to 21 percent of retail bank loans, while 61 percent of PPWC loans go to entrepreneurs and young firms that have been in business for less than five years. More than half (53 percent) of Kiva Zip's loans go to women-owned businesses and 63 percent to minority-owned businesses; this compares to 36 percent and 14.6 percent, respectively, of traditional retail bank loans.
- Online business loans can boost the growth of SMEs in underserved counties. PPWC recipients in counties that have lost ten or more bank branches since the 2008 financial crisis saw their PayPal sales soar by 22.4 percent from one year to the next, while comparable retail businesses in the U.S. grew by only 1.72 percent over the same period.⁷
- Online loan products have potentially significant economic benefits. Based on increased sales of businesses that have received PPWC loans, we estimate that programs like this have the potential to boost economic activity in the U.S. by \$697.95 billion, or 3.98 percent of the country's 2015 GDP.

This paper will begin by describing the challenges SMEs have traditionally faced in securing access to financing. It will then provide an analysis of the data that have led us to our conclusion about online business lending stepping in to fill the gap. The paper will then analyze the demography of the businesses securing online business loans and the economic opportunity online business lending pres-

ents. The paper concludes with a discussion of the policy issues associated with online lending products.

ASSESSING THE SME FINANCING GAP

Financial institutions have traditionally been the primary source of SME financing around the world. In the U.S., for example, the overwhelming majority of SMEs report that commercial retail banks (regional or community) are their primary financial institutions.⁸ SMEs in Europe obtain 85 percent of their loans from retail banks.⁹

In 2014, SME lending by the ten largest U.S. banks was down 38 percent from its peak in 2006.¹⁰ The number of bank branches in the U.S. decreased from 97,274 in 2007 to 94,725 in 2014, and some regions were disproportionately affected by this shake-out.¹¹ The global market for SME financing has yet to fully recover from the crisis; in 2013, outstanding SME loans and the number of new loans issued remained low in much of the developed world.¹²

SMEs have far more difficulty with access to finance than larger firms. They often face higher interest rates, shorter maturity, and more stringent collateral requirements.¹³ The smaller a firm, the more difficulty it has obtaining financing.¹⁴ A survey of European businesses found that large SMEs (50+ employees) are more likely than micro-SMEs (1-9 employees) to apply for bank loans and less likely to be concerned about rejection.¹⁵ A Federal Reserve Bank study confirmed this trend in the U.S., noting that financial institutions have traditionally viewed micro-SMEs as high-risk and expensive to do business with (i.e., high transaction costs and low returns).¹⁶ The study also found that 20 percent of all SMEs are discouraged from applying for loans in the first place, due to prohibitive application costs and low loan prospects. Therefore, it is not surprising that SMEs no longer look to traditional bank loans as a likely credit source.¹⁷

Research has provided a number of explanations for why SMEs have traditionally struggled to obtain capital, including:

- Poor record-keeping
- High risk and turnover in the sector
- Overreliance on internal financing
- Weak management
- Lack of assets to use for collateral
- Lack of a track record
- Lack of connections in the financial system
- Poor knowledge of financing options
- The high cost of finding a loan product that fits their needs¹⁸

Furthermore, lenders often lack access to third-party information regarding SME borrowers' credit profiles and histories. SME financing was further constrained in the wake of the financial crisis, as brick-and-mortar financial institutions were increasingly reluctant to engage in high-risk and relatively low-yield SME loans.¹⁹ Many workers who lost their jobs in the course of the crisis launched

Usman Ahmed, Thorsten Beck, Christine McDaniel, and Simon Schropp

businesses to make ends meet, and they faced tremendous credit constraints because they lacked the track record required to secure financing.²⁰ Existing SMEs were left vulnerable during the credit crisis, as shocks to their companies could not be absorbed due to the lack of access to short-term financing.²¹

ONLINE LENDING MAY FILL THE FINANCIAL GAP

The Internet is an interconnected global network that enables a seamless transfer of information among its more than three billion global users. In the last few years, this global communications network, combined with advanced analytics, has been leveraged to resolve some common barriers associated with SME lending. As we demonstrate below, technological developments in data capture, data analysis, and reporting have unleashed the potential for online lending to fill the SME financing gap.²²

New technologies can be applied to SME lending in a number of ways: SMEs can be assessed using new sources of first- and third-party financial information; forms can be simplified and accessed online; credit assessments can be conducted in short order, using objective criteria; funding can be disbursed in real time; and repayment schemes can be adjusted to the individual SME borrower's situation. Moreover, online loans can be tailored to the needs of SMEs. These businesses typically do not have large cash reserves, so small working-capital loans can address the cash-flow problems they commonly experience.²³ Jesse Hagen, a former vice president of the U.S. Bank Small Business Division, stated that 82 percent of businesses fail due to poor cash-flow practices.²⁴ In the United States, microloans (\$100,000 and under) account for 90 percent of SME loans.²⁵ Indeed, the need for small working-capital loans, which a traditional retail bank often considers too risky or low profit, can be filled by an online lender that can leverage technology and scale to overcome these difficulties.²⁶

Many firms that obtain financing online report having faced borrowing constraints that precluded them from obtaining traditional bank loan financing.²⁷ A survey by the National Endowment for Science, Technology and the Arts found that 33 percent of online borrowers said they likely would not have gotten funds through traditional bank loans.²⁸

Traditional loans often require the potential borrowers to provide secure collateral before obtaining financing, which can be difficult for smaller businesses, particularly those engaged in intangible products.²⁹ Thirty percent of businesses that responded to a recent survey by the Federal Reserve Bank of New York reported having insufficient collateral as the reason they were unable to obtain funding.³⁰ Lifting collateral requirements has been shown to increase access to credit, which has led to increased hiring and aggregate fixed assets for the businesses that receive financing.³¹ Traditional brick-and-mortar financial institutions continue to be extremely reluctant to lift collateral requirements, but not so online products. A significant percentage of online business loans are unsecured, meaning they do not require collateral.

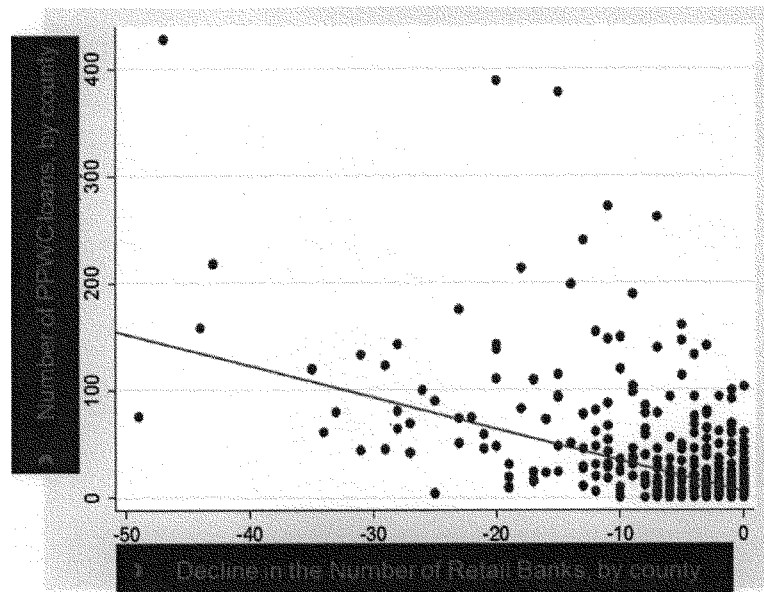


Figure 1. Online borrowing and bank departures

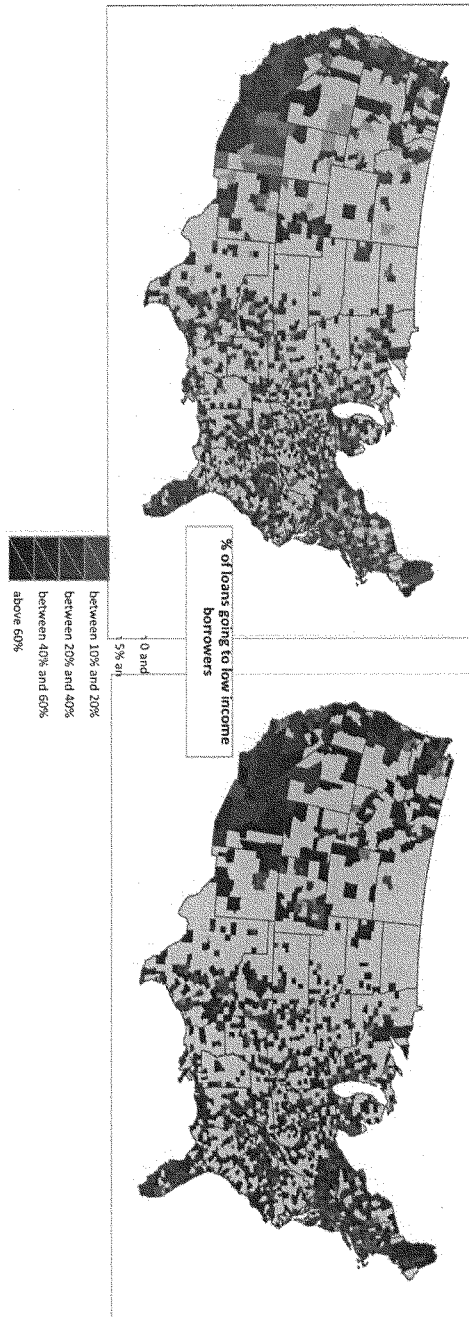
Source: PayPal data, Federal Deposit Insurance Corporation

Lifting the traditional barriers associated with SME financing may lead to positive developments in lending. Figure 1 plots two sets of data: the change in the number of U.S. bank branches between 2007 and 2014, by county (horizontal axis), and the number of PPWC loans made in the U.S. in 2014, by county (vertical axis). The red line reveals the relationship between the two data series, which is negative, with a correlation coefficient of -0.23. This relationship indicates that a higher proportion of PPWC loans are being disbursed in counties that lost the highest percentage of their traditional retail banks. The data also reveal that nearly 25 percent of PPWC loans were disbursed in the 3 percent of the counties that have lost ten or more banks since the 2008 financial crisis.

Technology companies and startups are not the only firms innovating in an effort to fill the SME financing gap. Wells Fargo, a retail bank with more than 6,000 retail branches in the U.S., for example, revamped its previously miniscule SME lending product to become the second largest SME lender in the country. As a result, 70 percent of Wells Fargo's revised data-enabled loan product went to businesses that employ five or fewer people, with an average loan size of just \$15,000.³² Moreover, collaborations between banks and technology companies are rapidly developing, which could lead to tremendous efficiencies in reaching underserved SMEs.³³

Usman Ahmed, Thorsten Beck, Christine McDaniel, and Simon Schropp

Figure 2. Loans made to low- and moderate-income firms
Source: PayPal data, Federal Deposit Insurance Corporation



Filling the Gap

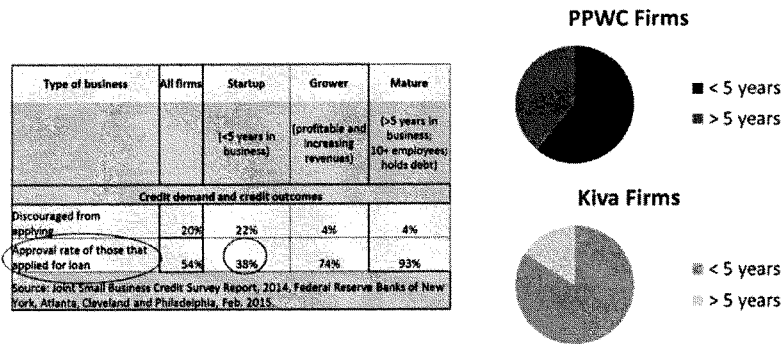


Figure 3. Lending to young firms

Source: PayPal, Kiva Zip

THE DEMOGRAPHY OF ONLINE BORROWERS

SME borrowers that use online channels to access financing come from nearly every sector and experience level. There are, however, some interesting characteristics unique to the SMEs that use online lending services. Online business loans disproportionately serve low-income, young, women-owned, and minority-owned firms.

Data from the Federal Deposit Insurance Commission indicate that approximately 21 percent of the retail bank loans under \$100,000 are taken out by low- and moderate-income businesses in the United States, compared to 33.7 percent of PPWC loans of the comparable amount. Low- and moderate-income businesses are rarely eligible for traditional loan products, due to the collateral and administrative requirements of traditional bank loans. A recent working paper by the National Bureau of Economic Research demonstrates that the credit expansion created by governments and financial institutions in the wake of the 2008 financial crisis did not serve borrowers with low-FICO scores (often low-income borrowers) effectively, but they did benefit those with high FICO scores (often high-income borrowers).³⁴ Figure 2 compares the U.S. loan activity by county between low-income businesses and traditional brick-and-mortar banks, and between these businesses and the PPWC product. The darker areas indicate that more loans were made to low-income borrowers.

Over the last decade, traditional bank financing has been more available for large established firms than small young firms, which has left the latter harder hit by the credit gap.³⁵ A recent survey by the Federal Reserve shows that the majority of small firms (less than \$1 million in revenues) and startups (fewer than five years in operation) in the U.S. are unable to secure credit.³⁶ Newer and younger firms were three times more likely than established firms to be fully or partially denied funding, and this discrepancy is not unique to the United States.³⁷ As a result,

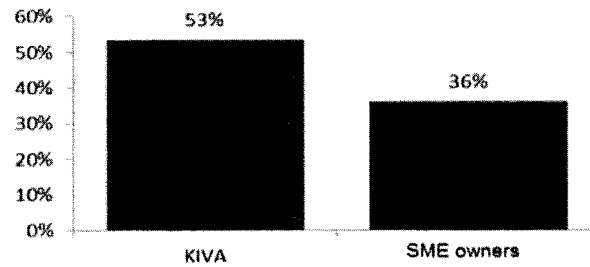


Figure 4. Women-owned businesses

Source: Kiva Zip data (2014) and Small Business Administration (2012)

younger firms that have struggled to secure financing now prefer to pursue the online alternatives. Figure 3 presents official U.S. data demonstrating the difficulty young firms face when trying to secure financing—only 38 percent are approved for loans. It also shows that 61 percent of PPWC loans and 84 percent of Kiva Zip loans go to young firms.

Women around the globe consistently have less access to financial resources than men.³⁸ Using U.S. Census Bureau data, the Economics and Statistics Administration reports that women are half as likely to start or acquire a firm using a business loan acquired from a traditional financial institution.³⁹ Meanwhile, women entrepreneurs are disproportionately represented among Kiva Zip borrowers: 36 percent of SMEs are female-owned, whereas 53 percent of Kiva Zip borrowers are women (see figure 4).

In the United States, women-owned firms grow at more than double the rate of other firms, and they are expected to create more than half of the new jobs in the U.S. in 2018.⁴⁰ If the financing issues of women-owned businesses are resolved, these numbers could be even greater.

Firms operated and/or owned by minorities have traditionally struggled to secure financing, and they tend to be younger and smaller than the average business. This puts them at an immediate disadvantage when accessing financing.⁴¹ Census Bureau data indicate that minorities are denied loans at 2.5 times the rate of non-minorities.⁴² Black, Asian, and Hispanic businesses have also struggled to secure loans since the 2008 financial crisis, particularly loans backed by the Small Business Administration, which has traditionally catered to minority-owned firms.⁴³ The Small Business Administration reports that only 14.6 percent of SMEs are minority owned, whereas 63 percent of the Kiva Zip loans go to minority-owned businesses (see figure 5).

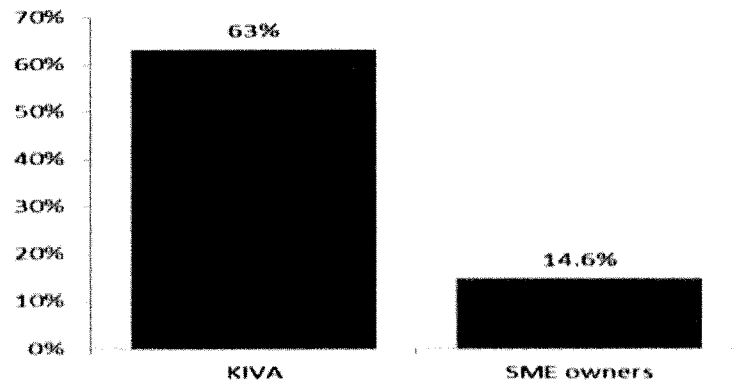


Figure 5. Minority-owned firms

Source: Kiva Zip data (2014) and Small Business Administration (2012)

THE ECONOMIC IMPACT

The World Economic Forum's 2015 Inclusive Growth and Development Report finds that access to financing is a key link between economic opportunity and outcomes.⁴⁴ Financing provided by the private sector can be powerful. A doubling of the amount of private-sector credit is associated with a two percentage point increase in the rate of GDP growth.⁴⁵

SMEs' access to online lending has resulted in strong growth trends for the participating companies. Research demonstrates that the most favorable growth rates result from having access to financing. One study finds that a 10 percent increase in funds is associated with a 14.68 percent increase in firm growth for a financially constrained firm, but only 3.82 percent for a financially unconstrained firm.⁴⁶ We analyzed the growth of firms receiving PPWC loans, which originated in the 3 percent of U.S. counties that have lost ten or more banks since the 2008 financial crisis. We found that sales by these businesses grew 22.4 percent between 2014 and 2015. The U.S. Census Bureau reports that similarly situated retail businesses across the U.S. only grew 1.72 percent in that same timeframe.⁴⁷ If the jump in sales spurred by an online business loan were extended to every underserved SME in the U.S., the nation's economic activity could increase by as much as \$697.95 billion, or 3.98 percent of 2015 GDP. We arrive at that number by taking a jump in sales following receipt of an online loan (20.68 percent) and multiplying it by the total sales generated by U.S. SMEs in 2015 (\$11.38 trillion). We only

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looked at SMEs the Federal Reserve Bank found were too discouraged to apply for traditional funding or had already been rejected (29.6 percent). To arrive at that last percentage, we consulted a recent Federal Reserve survey, which shows that 22 percent of SMEs applied for credit and 44 percent of them were not able to secure funding.⁴⁸ Moreover, 20 percent of SMEs are too discouraged to even apply. Together this suggests that 29.7 percent of SMEs (22% of 44% = 9.7%, plus the 20% just mentioned) are either rejected for a loan or too discouraged to apply for one. We note further that online lending not only results in economic growth for SMEs, it benefits consumers through, for example, increased product selection and lower costs.

Online lending also provides economic value to SMEs by bringing competition to the market for corporate lending, a sector that was sorely in need of new entrants, particularly in the wake of the financial crisis. Through consolidation and closings, the number of community banks in the United States has declined from 14,000 in the mid-1980s to just 7,000 today, and only three new commercial banks have opened in the United States since 2010.⁴⁹ Before the financial crisis, SMEs traditionally secured financing from community banks and thus have been disproportionately affected by these changes.⁵⁰

Information asymmetry has traditionally plagued SME financing. The lack of public information about the performance of SMEs can make it difficult to assess their creditworthiness. Increased competition among lenders could help to promote innovative solutions to information asymmetry, as well as to alleviate financial constraints for the SME sector.⁵¹ Because the lending market has traditionally failed to meet demand, governments around the world have stepped in to provide SME financing, particularly during financial crises, when constraints on borrowing are exacerbated.⁵² The benefits of increased competition brought on by online financing might obviate the need for these government programs, which tend to operate at less than optimal efficiency.⁵³

Finally, competition from online lending may reduce systemic risk. The Organization for Economic Cooperation and Development has found that firms that solely have access to capital through traditional bank loans are more vulnerable during crises.⁵⁴ SMEs have largely been tied financially to a select group of institutions—namely, community banks—and when these banks started to disappear, SMEs were greatly affected. Online lending provides more diversified lending options, which can reduce borrowers' exposure while also spreading the risk across a broader ecosystem.

Online business lending is still in its infancy; most providers started within the past decade. Nevertheless, recent Federal Reserve Bank studies have found that 20 percent of SMEs have attempted to secure credit from an online lender.⁵⁵ A Greenwich Associates survey of 218 SMEs found that nearly 25 percent of respondents had obtained credit from an online provider in the past 18 months. The economic impact of online business lending is likely to grow in the future.

POLICY ISSUES

Policymakers must recognize that a multitude of business models are being employed in the online business lending space, some of which warrant more scrutiny than others. If the interests of a lender and a borrowing business are aligned and the lender is invested in a borrower's success, then there may be less need for government scrutiny.⁵⁶ Moreover, risk assessment and collection practices differ across the online business lending industry. Models that assess risk without sound data and collection practices should be scrutinized, since they contain inefficiencies and hence result in higher fees. Many of the new types of financial services have links with existing regulated financial institutions. Therefore, to the extent that regulators look to propose additional rules for new financial services, it is essential to understand the existing landscape and avoid redundant and inefficient regulations.

It is also worth noting that a host of regulations already govern the online business space. In the U.S., for example, online lenders are subject to Section 5 of the Federal Trade Commission Act (prohibiting unfair or deceptive practices) and the Equal Credit Opportunity Act (prohibiting lenders from issuing credit based on race, sex, age, religion, etc.).⁵⁷ Moreover, a significant portion of online business loans are originated by traditional financial institutions, which are already subject to a host of regulations.

Policymakers must understand the difference between online business lending products and traditional lending products. Online SME loans are often short-term financial products, and the total cost of the loan can be calculated using an annualized percentage rate (APR) or a fee-based model (the loan amount includes additional fixed costs). Policies regulating traditional loan products often center around APRs, but this annualized measure often makes no sense for a product that might have a term of three months. Therefore, an SME may understand the actual costs of the fixed-fee better than an APR. Policymakers should analyze the differences between online loan offerings to determine which may be harmful to SMEs.

Finally, although this paper focuses largely on the U.S., the global nature of the Internet means that online business loans can be made across international borders. However, the differing regulations between countries, and even within countries, temper the wide reach of these online platforms. In the U.S., divergent state banking rules on licensing, interest rates, consumer protection, and due diligence threaten the ability of online business lenders to provide a uniform experience.⁵⁸ Policymakers should work to harmonize online business lending rules across intra- and inter-country boundaries.

CONCLUSION

Traditional financial services are rapidly being reformed by technology. An estimated \$20 billion in venture capital was expected to be invested in financial technology businesses in 2015, a 66 percent increase over the previous year.⁵⁹ Startups,

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large financial institutions, and technology companies are adapting to these changes and creating new financial services solutions that have the potential to fill the gap in SME financing that developed in the wake of the 2008 financial crisis. Moreover, the impact these new products could have for the broader economy, in particular for financially underserved firms, is noteworthy. Policy interventions that affect new SME financing products must be carefully considered.

Acknowledgments

The authors wish to thank Olim Latipov, Kornel Mahlstein and Pierre-Louis Vézina for their valuable input, and Jegan Velappan Pillai for his data expertise. All opinions expressed in this paper are the authors' and should not be attributed to the institutions they are affiliated with, nor with the clients they represent. As usual, any errors, flaws, or lapses remain solely the authors' responsibility.

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House Small Business Committee Hearing

Financing through Fintech: Online Lending's Role in Improving Small Business Capital Access

October 26, 2018

Chairman Brat, Ranking Member Evans, and distinguished Members of the Committee:

PayPal Inc. appreciates the opportunity to provide this written statement for the record of the October 26, 2017 hearing titled, "Financing Through Fintech: Online Lending's Role in Improving Small Business Capital Access." In this statement, we will share with the Committee PayPal's experience as a financial technology, or "fintech," platform providing access to much-needed capital to small businesses and the gap we see that these loans are filling. In addition to this statement, we would like to submit a report published in MIT's Innovations publication entitled "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises."

PayPal, Small Businesses, and PayPal Working Capital

As you know, small businesses play a critical role in the global economy. They hire neighbors and strengthen communities. They drive economic impact. Small businesses consistently report access to capital as being one of the most important factors in being successful. However, while lending to large firms has largely rebounded since the Great Recession, lending to small businesses has down approximately 20% over the same period¹. This gap in access to capital can disproportionately hit businesses that are young, women, or minority-owned². At PayPal, we see it as a privilege to empower small businesses by providing financial services and tools that help them compete in the marketplace.

PayPal introduced PayPal Working Capital in 2013, a unique business financing product that has provided access to more than \$3 billion in funding to over 115,000 small businesses globally. PayPal Working Capital aims to help fill the gap in access to financing, using innovative and relevant data to enable informed and quicker decisions about a small business.

PayPal Working Capital is a business loan of a fixed amount with a single fixed fee for merchants who have been doing business using PayPal for at least three months. Additional eligibility is based on PayPal history and processing volume, not a business or personal credit score like traditional sources. Small business owners select a loan amount (up to maximum of 30% of their annual PayPal sales) and if approved, the loan amount is deposited to the business owner's PayPal account within minutes. Payments are applied automatically as a fixed percentage of sales between 10-30% at a level the merchant chooses until the balance is paid in full – meaning merchants pay more when business is strong and less during slower times.³ There are no periodic interest charges, late fees, or

¹ Mills, Karen Gordon, McCarthy, Braden. (2014) The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game. Harvard Business School

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³ Subject to a minimum payment requirement due every 90 days.

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penalty fees, and loans must be paid in full before a merchant can apply for another loan. The average fixed fee is less than 10% of the amount borrowed.

Filling the Gap

- From 2013-2014, we found that 25% of PayPal Working Capital loans in the United States were disbursed to the 3% of counties that have lost 10 or more bank branches since the 2008 financial crisis⁴.
- The recipients in these counties saw sales increase by 22.4% from one year to the next, while comparable retail businesses in the U.S. grew by 1.72% over the same period.
- In the period when the study was conducted, 61% of PayPal Working Capital loans went to entrepreneurs and young firms that have been in business less than 5 years.
- During the time period studied, approximately 90% of businesses that paid off their initial loan reapplied for funding, and 85-90% of respondents asked to rate the program on a scale of 1-10 answered with a 9 or 10.
- More than half of businesses used PayPal Working Capital funds for inventory while others used it for seasonal hiring, marketing and promotion, expansion and cash flow management.

PPWC Case Studies

Nikki Gentry is from O'Fallon, MO, and started her company My Dreamlines after graduating from college with a degree in marketing. She jumped between a couple of marketing jobs but then decided to start her own business utilizing artists around the country to draw sketches of wedding photographs the clients provide. Since the beginning in 2014, Nikki has been using PayPal to process payments on her website. Later she turned to PayPal Working Capital to help with cash flow during the slower months. Using PayPal Working Capital has allowed Nikki to hire more artists and expand choices for her customers.

Says Nikki:

"It is really a huge weight off my mind knowing that I have that extra little bit of financing when I need it to take advantage of a marketing opportunity, or buy some much needed supplies. It helps me breath and not panic."

Zeke Freeman, Owner and Founder of Bee Raw in Brooklyn, NY, discovered a fledging artisanal honey company after years in kitchens as a chef around the world. He helped create an elegant brand and image around the product, and ten years later, after taking ownership of the company, Bee Raw is flourishing in the finest shops around the country. To Zeke, Bee Raw is a more than a business; it is a way of life. He makes it a priority to promote American family-owned apiaries and artisans who have struggled in the commoditized environment of the honey industry.

⁴ "Filling the Gap: How Technology Enables Access to Finance for Small and Medium Sized Enterprises" Paper authored by Usman Ahmed, Head of Global Public Policy at PayPal Inc. and an adjunct professor of law at Georgetown University, Thorsten Beck, professor of banking and finance at Cass Business School in London, Christine McDaniel, Senior Economist at Sidley Austin LLP, and Simon Schropp, Managing Economist at Sidley Austin LLP. Published in innovations: technology | governance | globalization, Volume 10, Issue 3-4 – Summer-Fall 2015 – Financial Inclusion (Part II), pages 35-48

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Says Zeke:

"We have a very capital intense business because farmers produce and sell their honey once a year in the summer months. That means that we have to buy all of our inventory for the year in those months, which can make cash flow tight. PayPal Working Capital is so convenient and easy. It really helps us."

Closing

PayPal has a proud history of helping our merchants grow and thrive. We are pleased the Committee shares our goal to enable America's small businesses to access the funds they need to succeed in a transparent, responsible, and fair way. We look forward to working with Committee members to ensure innovative tools such as PayPal Working Capital remain as the dream fuel for our merchants well into the future.

Thank you for allowing us to contribute and submit this statement today.



Testimony for the Record

**Submitted to the
House Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access**

**For the Hearing
“Financing through Fintech: Online Lending’s Role in
Improving Small Business Capital Access”
October 25, 2017**

Submitted by Alison Feighan on behalf of the Responsible Business Lending Coalition

Chairman Brat and Ranking Member Evans, on behalf of the Responsible Business Lending Coalition (RBLC) I thank you for convening this important hearing. We hope that today’s discussion will launch an ongoing dialogue to encourage much needed innovation in small business lending, while also empowering and protecting small businesses borrowers from irresponsible lending practices and products. We appreciate the opportunity to contribute to this dialogue by submitting testimony related to the *Small Business Borrowers’ Bill of Rights* and RBLC’s efforts to drive responsible practice in the small business lending space.

The RBLC is a diverse network of experienced for-profit and nonprofit lenders, brokers, and small business advocates organized to promote responsible innovation in small business lending and combat the rise of predatory and irresponsible lending practices and products in the market. The RBLC’s members are the Aspen Institute, a nonpartisan policy forum; Funding Circle and Lending Club, two leading Fintech innovators in marketplace lending; Accion and Opportunity Fund, two of the largest nonprofit CDFI small business lenders; Fundera, a leading small business loan broker; Community Investing Management, an impact-driven investor in small business financing; and the Small Business Majority, a nonprofit trade association and advocate for small businesses.

Members of the RBLC recognize that the way small businesses borrow money is changing and innovation is providing faster and easier access to capital, particularly in communities historically underserved by traditional lenders. The RBLC believes that in order to effectively empower small businesses, these innovations must place transparency, fairness, and borrowers’ rights at the center of the lending process. To that end, the RBLC created the *Small Business Borrowers’ Bill of Rights*, a cross-sector consensus on the responsible lending practices that all small business owners seeking financing deserve. More than simply a statement of principles, the *Small Business Borrowers’ Bill of Rights* is a set of specific practices that lenders, marketplaces, and brokers should abide by to uphold the rights of their small business customers. The six rights are:

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

Since released two years ago, some 90 organizations including for-profit fintech innovators, nonprofit CDFI lenders, advocacy and community groups, investors, brokers, and marketplaces have signed on to the *Small Business Borrowers' Bill of Rights* as Signatories or Endorsers. To become a "Signatory," the CEO or chief executive of a lender, marketplace, or broker must sign an attestation form affirming that the organization abides by each and every relevant practice set forth in the *Small Business Borrowers' Bill of Rights*. There is no option to abide by certain requirements and ignore others. A Signatory's CEO is required to sign a standard Attestation Form designed for either a lender or marketplace, or a broker. Organizations that do not provide lending or brokering services, such as think tanks and advocates, can sign on as "Endorsers."

At the end of this statement we have attached a copy of the *Small Business Borrowers' Bill of Rights*, lender and the broker Attestation Forms, and a current list of signatories and endorsers.

Why a Small Business Borrowers' Bill of Rights?

The small business financing landscape continues to change at a rapid pace, with new technologies, new lenders, and new products coming on line daily – some good and some not so good. While the RBLC supports efforts to make capital more accessible, particularly to entrepreneurs in underserved communities, we would like to see as much attention given to the quality of that capital and ensuring that in the long run, capital is helping and not harming small businesses. We continue to see evidence of the abusive and deceptive lending practices that led the formation of the RBLC and the launch of the *Small Business Borrowers' Bill of Rights*, including:

- a) Obfuscation of very high financing costs
- b) Misaligned incentives between lenders and borrowers

- c) Double-charging borrowers when loans are renewed by “double dipping”
- d) Mismatch between financial products’ purported use and behavior encouraged by the provider
- e) Hidden prepayment charges
- f) Misaligned broker incentives steering small businesses into expensive products
- g) “Stacking” of too much debt
- h) Lack of legal protections in collections, and
- i) Need for financial inclusion

The Rights were developed as industry-driven standards of accountability and transparency, in the absence of small business lending regulation. The majority of state and federal laws that apply to consumer loans do not apply to small business loans and there is no federal regulator overseeing small business lending.

The Rights apply to all types of lending institutions that serve small businesses, including traditional financial institutions, CDFIs and other mission-driven lenders, as well as fintech lenders, marketplaces, and brokers. Similarly, the Rights apply to the full range of small business financing products available. In the *Small Business Borrowers’ Bill of Rights* and Attestation Forms, the term “loan” and related terms such as “lending” are intended to include loans, lines of credit, merchant cash advances, and similar products that extend credit to U.S. small businesses, but may or may not be advertised as “loans.” Similarly, the terms “lender” and “borrower” are intended to be interpreted in the broadest sense possible to include credit marketplaces that facilitate loans on behalf of lenders, cash advance providers, and all manner of persons providing loans to a small business or evaluating the creditworthiness of a small business seeking a loan. In the case of borrowers, the Rights apply to all U.S. small businesses who seek or obtain financing.

Advancing Transparency

As the text of the Small Business Borrowers’ Bill of Rights indicates, the RBLC believes that transparency is critical to enabling small business owners to access capital that will benefit their businesses. Standardized disclosure elements that apply to all loans, lines of credit, merchant cash advances, and similar products are an important means to achieve greater transparency. To that end, we have engaged with colleagues in the industry – including those that have become signatories of the *Small Business Borrowers’ Bill of Rights*, and those that have not – to discuss standardized disclosure, and we will continue that dialogue.

The RBLC believes the purpose of standardized disclosure is to enable borrowers to understand the *cost*, *terms*, and *affordability* of the financing being offered, to effectively compare financing options and make an informed decision. Disclosures that offer only partial information, or that use terminology that is not well understood by borrowers make it more challenging for business owners to make choices that are in their best interest. With that goal in mind, the RBLC supports standardized disclosure that includes the following six elements:

1. **Amount:** The total amount paid to a borrower (with fees deducted) must be disclosed.

2. **Annualized Percentage Rate (APR):** The APR, as the all-in annualized price of the financing, is the best metric to help borrowers effectively evaluate and compare the price of financing products and therefore must be disclosed. In the case of a merchant cash advance (MCA) a lender would disclose an “estimated APR.”
3. **Total Monthly Payments:** The total monthly payment is the best metric to help a borrower evaluate affordability and therefore must be disclosed. If payment frequency is not monthly, a lender must calculate the estimated monthly payment and disclose the frequency and amounts of each payment (e.g. \$xx each weekday) and in the case of a MCA, a lender must disclose how payments are calculated and with what frequency payments are due (e.g. X % of every dollar in sales to be deducted daily until \$xx is repaid).
4. **Term:** The term of the financing must be disclosed – either in months or years – and if the term is not fixed then the lender must disclose the “estimated term.”
5. **Total Cost:** The total cost of the financing must be disclosed and broken down, so a borrower can understand what expenses and/or fees are included in the total cost (e.g. Interest Expense = \$xx, Origination Fee = \$xx).
6. **Prepayment Cost/Savings:** To assess the cost of financing, a borrower must be able to account for any cost or savings associated with prepayment. Therefore, a lender must disclose if there is a cost (or a benefit) to the borrower associated with prepayment (e.g. Prepayment Cost/Savings = Up to \$xx).

In addition, the RBLC believes the following elements **must not be included** in standardized disclosure:

- a) Standardized disclosure **should not** reference metrics or percentage rates other than interest rate or APR. Metrics such as “Simple Interest” or “Factor Rate” or references to “payment multipliers” or other terms can too easily be confused with an interest rate and using such term undermines an applicant’s ability to effectively compare financing options.
- b) Standardized disclosure **should not** emphasize any element **above** the Amount, APR and Total Monthly Payment. These three elements should be emphasized above other elements disclosed, as they are most critical to an applicant’s understanding of a loan’s benefits, price, and affordability.
- c) Standardized disclosure **should not** disclose information unless it contributes directly to an applicant’s ability to understand the cost, terms, and affordability of the financing available to them. A summary section should be limited to key factors that help an applicant understand and compare the cost and affordability of financing in the simplest way possible.

Again, on behalf of the RBLC, I thank you for the opportunity to contribute to the subcommittee’s hearing. Please know we are available to answer any follow up questions about the *Small Business Borrowers’ Bill of Rights* or any of the information provided in our testimony. We look forward to working with the committee as you continue to explore how fintech innovations can encourage and facilitate responsible small business lending.



SMALL BUSINESS BORROWERS' BILL OF RIGHTS

The way small businesses borrow money is being transformed. Innovators are providing faster and easier ways to borrow and increasing access to credit in communities that have historically been underserved. This transformation will achieve its potential only if it is built on transparency, fairness, and putting the rights of borrowers at the center of the lending process.ⁱ To that end, we have identified the fundamental financing rights that we believe all small businesses deserve. These rights are not yet protected by law, in most cases. We encourage the entire small business financing industry to join us in upholding these rights.

1. The Right to Transparent Pricing and Terms

You have a right to see the cost and terms of any financing being offered in writing and in a form that is *clear, complete, and easy to compare* with other options, so that you can make the best decision for your business. In order to protect your Right to Transparent Pricing and Terms, lenders and brokers must:

- **Transparent Rate** – Disclose the Annual Percentage Rate (APR),ⁱⁱ as the all-in annualized price of the financing, and the annualized interest rate if one is used.
- **No Hidden Fees** – Disclose all upfront and scheduled charges.
- **Plain-English Terms** – Describe all key terms in an easy-to-understand manner, including the loan amount, total amount provided after deducting fees or charges, payment amount and frequency, total monthly payment amount if payment frequency is other than monthly, collateral requirements, and any prepayment charges.
- **Clear Comparison** – Present all of these pricing and other key terms clearly and prominently, in writing, to the borrower when the loan offer is summarized for the borrower and whenever a term sheet, offer summary, or equivalent is provided.

2. The Right to Non-Abusive Products

You have a right to loan products that will not trap you in an expensive cycle of re-borrowing. Lenders' profitability should come from your success not from your failure to repay the loan according to its original terms. In order to protect your Right to Non-Abusive Products, lenders must:

- **No Debt Traps** – If the borrower is unable to repay an existing loan, extend new credit only if due diligence indicates that the borrower's situation has changed, enabling them to repay the new loan.
- **No "Double Dipping"** – Do not double-charge the borrower. When refinancing or modifying a loan with a fixed-fee as the primary financing charge, do not charge fees on the borrower's outstanding principal unless there is a tangible cost benefit to the borrower.ⁱⁱⁱ
- **No Hidden Prepayment Charges** – If the borrower receives no savings, or limited savings, in early payoff, disclose this in the original loan term sheet or offer summary, and again at the time of payoff. For financing with a fixed term, if a prepaying borrower owes a fixed repayment amount or a certain percentage of that amount regardless of when they pay off the financing, disclose this as prepayment charge. This charge is equal to the remaining financing charge owed at payoff, which is the cost the borrower is paying for the unused portion of the loan.

- **Appropriate Product** – Match loan product design and loan product use. If presenting a loan product as designed for one use, do not encourage borrowing behavior contrary to that use. For example, short-term products may be well suited for short term use, but not for long-term recurring use. Long-term products with prepayment penalties may be well suited for long-term use, but not for short-term needs.
- **Pressure Free** – Allow borrowers a reasonable time to consider their loan options free from pressure or artificial timelines.
- **Prompt Prepayment Assistance** – If a borrower seeks to prepay a loan, provide any information required for prepayment within two business days of the borrower's request.
- **Responsive Complaint Management** – If a complaint is submitted, provide a confirmation of receipt within five days and in writing, when possible, and research and resolve the complaint in a timely manner.^{iv}
- **Clear Notice Regarding Referrals** - If referring a small business to another lender or broker, provide clear notice that a referral is being made. If the lender or broker is not already a signatory of the *Small Business Borrowers' Bill of Rights* and thus has agreed to clear disclosure and responsible lending practices, inform borrowers that as they move forward they should consider key aspects of any financing offered – the APR, the total payment amount owed monthly (even if payments are made daily or weekly), their ability to pay off any financing they take, and whether they may owe financing charges even if they pay off early.

3. The Right to Responsible Underwriting

You have a right to work with lenders who will set you up for success, not failure. High loss rates should not be accepted by lenders simply as a cost of business to be passed on to you in the form of high rates or fees. In order to protect your Right to Responsible Underwriting, lenders must:

- **Believe in the Borrower** – Offer financing only with high confidence that the borrower can repay its *entire* debt burden without defaulting or re-borrowing.
- **Alignment of Interests** – Lenders who receive repayment directly from the borrower's gross sales must also verify, through documents, data from third parties, and/or due diligence, that the borrower can repay all debt and remain profitable, or that it has a credible path to profitability. Lenders should not make loans that the borrower cannot truly afford, even if the lender can find a way to be repaid.
- **Right-sized Financing** – Size loans to meet the borrower's need, rather than to maximize the lender's or broker's revenue. Seek to offer the borrower the size of loan that they need, rather than offering the largest amount they could qualify for.
- **Responsible Credit Reporting** – Report loan repayment information to major credit bureaus and consult credit data when underwriting a loan. Such reporting enables other lenders to responsibly underwrite the borrower and helps the borrower build a credit profile that may facilitate access to more affordable loans in the future. Lenders must inform the borrower and any guarantors if they intend to report loan repayment performance to guarantors' credit bureaus only in certain circumstances, such as after a default.

4. The Right to Fair Treatment from Brokers

You have a right to transparency, honesty, and impartiality in all of your interactions with brokers. In order to protect your Right to Fair Treatment from Brokers, brokers must offer:

- **Transparent Loan Options** – Disclose all loan options for which the borrower qualifies through the broker's services, emphasizing the lowest APR option, and disclose all lenders to which the broker sends loan applications on the borrower's behalf.
- **Transparent Broker Fees** – Disclose all compensation paid to the broker, and all charges that will be paid directly or indirectly by the borrower, whether paid up front or financed in the loan.
- **Transparent Results** – Post clearly and prominently on the broker's website the anonymous and aggregated results of borrowers who obtain financing through the brokers' services, in terms of APR and financing product.
- **Empower Borrowers to Make Informed Financing Decisions** – Educate the borrower on each loan option and ensure that the borrower reasonably understands the cost and terms as well as the pros and cons of financing decisions *before* they sign a loan document. Brokers should use tools that help the potential borrower comparison shop, including APRs and loan calculators.
- **Disclosure of Conflicts of Interest** – Disclose any conflicts of interest, the broker's fee structure, and any financial incentives they have, including whether the broker receives higher fees for brokering certain loans. Brokers who are paid higher fees with certain lenders, loan types, or terms other than the size of the loan, may not state they are acting in the best interest of the potential borrower.
- **No Fees for Failure** – No fees can be charged to the potential borrower if the broker is unable to find them a loan and if the borrower does not accept a loan secured through the broker's services.
- **Responsive Complaint Management** – If a complaint is submitted, provide a confirmation of receipt within five days and in writing, when possible, and research and resolve the complaint in a timely manner.

5. The Right to Inclusive Credit Access

You have a right to fair and equal treatment when seeking a loan. In order to protect your Right to Inclusive Credit Access, lenders and brokers must:

- **Non-Discrimination** – Respect the letter and intent of fair lending laws, including the Equal Credit Opportunity Act. Do not discriminate against small business owners on the basis of race, color, religion, national origin, sex, marital status, age, sexual orientation or identity, or any other protected class. Lesbian, Gay, Bisexual and Transgender (LGBT) small business owners deserve the same protection when seeking or obtaining credit.

6. The Right to Fair Collection Practices

You have a right to be treated fairly and respectfully throughout a collections process. Collections on defaulted loans should not be used by lenders as a primary source of repayment. In order to protect your Right to Fair Collections Practices, lenders must:

- **Fair Treatment** – Abide by the spirit of the Fair Debt Collection Practices Act and provide borrowers similar protections as described in that Act.
- **Responsible Oversight** – Diligently vet and oversee the collections practices of third-party collectors and debt buyers. Do not work with collectors or debt buyers who fail to treat borrowers fairly.
- **Accurate Information** – Transmit accurate, current, and complete information about the loan to third-party collectors and debt buyers.

Product of the **Responsible Business Lending Coalition**

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ⁱ The term “loan” and related terms used here such as “lending” are intended to be interpreted in the broadest sense possible so as to include loans, lines of credit, merchant cash advances, and similar products offered and provided to U.S. small businesses, whether or not such credit products are characterized legally or otherwise as loans. Similarly, the terms “lender” and “borrower” are intended to be interpreted in the broadest sense possible so as to include, in the case of lenders, credit marketplaces that facilitate loans on behalf of lenders, cash advance providers, and all manner of persons providing loans to U.S. small businesses or evaluating the creditworthiness of such small businesses in connection with providing a loan, and, in the case of borrowers, all U.S. small businesses who seek or obtain a loan.

ⁱⁱ APR (annual percentage rate) is the annual rate that is charged for borrowing, expressed as a single percentage number. It includes fees as well as interest rate, and represents the actual yearly cost of funds.

ⁱⁱⁱ While it may be appropriate to charge a reasonable service fee for loan modifications that clearly help the borrower, it is not acceptable to effectively double-charge the borrower while refinancing or renewing by assessing the predominant financing charge, such as a 20% factor rate, on a borrower’s outstanding principal, which they have already paid for.

^{iv} While recognizing that some situations may require more time to resolve, a lender will be expected to research and resolve a complaint in less than three weeks.

The Responsible Business Lending Coalition
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SMALL BUSINESS BORROWERS' BILL OF RIGHTS

Small Business Borrowers' Bill of Rights (2.0 Update)

Attestation Form and Attestation Worksheet for Lenders and Marketplaces

In order for a lender or marketplace to become a signatory of the Small Business Borrower's Bill of Rights 2.0, its chief executive must attest that it abides by all practices described in the Small Business Borrowers' Bill of Rights by completing both the **Attestation Form** and the **Attestation Worksheet** below. Once completed, the documents should be emailed to info@responsiblebusinesslending.org.

Small Business Borrowers' Bill of Rights (2.0 Update) Attestation Form for Lenders and Credit Marketplaces

Summary of Attestation

By checking the boxes below, I affirm that my organization actively supports and adheres to the *Small Business Borrowers' Bill of Rights (2.0 Update)* and abides by all of the practices described in the attached Attestation Worksheet:

- ☐ The Right to Transparent Pricing and Terms
- ☐ The Right to Non-Abusive Products
- ☐ The Right to Responsible Underwriting
- ☐ The Right to Inclusive Credit Access
- ☐ The Right to Fair Collections Practices

Note: You must be able to truthfully check all five boxes to be deemed a Signatory of the Small Business Borrowers' Bill of Rights and thereby eligible to have your organization's logo appear on the Small Business Borrowers' Bill of Rights website, www.ResponsibleBusinessLending.org.

Terms of this Attestation

- a. I have read and understand the *Small Business Borrowers' Bill of Rights (2.0 Update)*.
- b. I have completed the attached Attestation Worksheet, indicating in writing that my organization abides by *all* of the enumerated practices.
- c. By completing this Attestation Form and attesting that my organization abides by *all* of the enumerated practices in the attached Attestation Worksheet, I consent to having this Attestation Form and my organization's logo posted on the Small Business Borrowers' Bill of Rights Website.
- d. I understand that this Attestation Form and my organization's logo may be removed from the Small Business Borrowers' Bill of Rights website if my organization does not complete and submit a satisfactory updated Attestation Form within one calendar year from the date of my signature below, and each successive year thereafter, or if my organization ceases to abide by this Attestation.
- e. I agree, on behalf of my organization, that my organization assents to and will be bound by the Terms of Use for the Small Business Borrowers' Bill of Rights website.
- f. Anyone with questions for my organization regarding this Attestation Form completed by my organization can contact the following individual (include name, title, email address, and phone number):

- g. I attest that the information above is accurate and represents the standard practices for all financing products and services offered through my organization to small businesses. Furthermore, I hereby certify that I am authorized to sign this Attestation Form on behalf of my organization.

Organization Name

Chief Executive Signature

Chief Executive Name

Date

Small Business Borrowers' Bill of Rights (2.0 Update)

Attestation Worksheet for Lenders and Marketplaces

In order for an organization to become a signatory it must attest that it abides by the Small Business Borrowers' Bill of Rights (2.0 Update) by having its chief executive complete this worksheet by checking each box below indicating that his or her organization abides by each of the practices set forth below.¹ Questions regarding the form can be directed to info@responsiblebusinesslending.org.

The Right to Transparent Pricing and Terms

- ☐ **Transparent Rate**
 - Disclose the Annual Percentage Rate (APR) and the annualized interest rate if one is used.
- ☐ The disclosure of APR is an addition of this 2.0 Update. The previous version of the Small Business Borrowers Bill of Rights required disclosure of annualized interest rates. An organization that is not already disclosing APRs may nonetheless complete this Attestation by checking this box, but must begin disclosing APRs as described here within 180 days of signing this Attestation. The organization agrees to provide evidence of disclosure of APRs within that time to info@responsiblebusinesslending.org.
 - Interest rate is defined as the scheduled or periodic financing cost, other than an upfront cost, expressed as a percentage of the outstanding principal and annualized.
 - APR is the annual rate that is charged for borrowing, expressed as a single percentage number. It includes fees as well as interest rate, and represents the actual yearly cost of funds.
 - Interest rates and APR are a percentage of outstanding principal balance, not of the original financing amount.
 - For lines of credit or other open-ended types of financing, rates must be calculated with reasonable assumptions about use, including assuming that the borrower draws the full amount on the origination date, and makes the minimum payments required.
 - If a rate is promotional or introductory, the term sheet or its equivalent should clearly state this, and how the rate could change in the future.
- ☐ **No Hidden Fees**
 - Disclose all upfront and scheduled charges.
- ☐ **Plain-English Terms**
 - Describe all key terms in an easy-to-understand manner, including the loan amount, total amount provided after deducting fees or charges, payment amount and frequency, total monthly payment amount if payment frequency is other than monthly, collateral requirements, and any prepayment charges

¹ The term "loan" and related terms used here such as "lending" are intended to be interpreted in the broadest sense possible so as to include loans, lines of credit, merchant cash advances, and similar products offered and provided to U.S. small businesses, whether or not such credit products are characterized legally or otherwise as loans. Similarly, the terms "lender" and "borrower" are intended to be interpreted in the broadest sense possible so as to include, in the case of lenders, credit marketplaces that facilitate loans on behalf of lenders, cash advance providers, and all manner of persons providing loans to U.S. small businesses or evaluating the creditworthiness of such small businesses in connection with providing a loan, and, in the case of borrowers, all U.S. small businesses who seek or obtain a loan.

- ☐ Clear Comparison
 - Present all of these pricing and other key terms clearly and prominently, in writing, to the borrower when the loan offer is summarized for the borrower and whenever a term sheet, offer summary, or equivalent is provided.

The Right to Non-Abusive Products

- ☐ No Debt Traps
 - If a borrower is unable to repay an existing loan, extend new credit only if due diligence indicates that the borrower's situation has changed, enabling them to repay a new loan.
- ☐ No "Double Dipping"

Do not double-charge the borrower. When refinancing or modifying a loan with a fixed-fee as the primary financing charge, no fees are charged on the borrower's outstanding principal unless there is a tangible cost benefit to the borrower.
- ☐ No Hidden Prepayment Charges
 - If a borrower receives no savings, or limited savings, in early payoff, this information is disclosed in the original loan term sheet or offer summary, and again at the time of payoff. For financing with a fixed term, if a prepaying borrower owes a fixed repayment amount or a certain percentage of that amount regardless of when they pay off the financing, this information is disclosed as a prepayment charge. This charge is equal to the remaining financing charge owed at payoff, which is the cost the borrower is paying for the unused portion of the loan.
- ☐ Appropriate Product
 - Match loan product design and loan product use. If presenting a loan product as designed for one use, do not encourage borrowing behavior contrary to that use. For example, short-term products may be well suited for short term use, but not for long-term recurring use. Long-term products with prepayment penalties may be well suited for long-term use, but not for short-term needs.
- ☐ Pressure Free
 - Allow potential borrowers to consider their credit options free from pressure or artificial timelines.
- ☐ Prompt Prepayment Assistance
 - If a borrower seeks to prepay a loan, provide any information required for the prepayment within two business days of the borrower's request.
- ☐ Responsive Complaint Management
 - If a borrower complaint is submitted, provide a confirmation of receipt in writing within five days when possible, and research and resolve the issue in a timely manner.

☐ Clear Notice Regarding Referrals

- If referring a small business to another lender or broker, provide clear notice that a referral is being made. If the lender or broker is not already a signatory of the *Small Business Borrowers' Bill of Rights* and thus has agreed to clear disclosure and responsible lending practices, inform borrowers that as they move forward they should consider key aspects of any financing offered – the APR, the total payment amount owed monthly (even if payments are made daily or weekly), their ability to pay off any financing they take, and whether they may owe financing charges even if they pay off early.

- ☐ The provision of this “clear notice” statement is an addition of this 2.0 Update. An organization that is not already abiding by this requirement may nonetheless complete this Attestation by checking this box, but must begin abiding by this requirement within 180 days of signing this Attestation. The organization agrees to provide evidence of abiding by this requirement within that time to info@responsiblebusinesslending.org.

The Right to Responsible Underwriting

☐ Believe in the Borrower

- Offer financing only with high confidence that the borrower can repay its *entire* debt burden without defaulting or re-borrowing.

☐ Alignment of Interests

- Lenders who receive repayment directly the borrower's gross sales must also verify, through documents, data from third parties, and/or due diligence, that the borrower can repay all debt and remain profitable, or that it has a credible path to profitability. Lenders should not make loans that the borrower cannot truly afford, even if the lender can find a way to be repaid

☐ Right-sized Financing

- Size loans to meet the borrower's need, rather than to maximize the lender's or broker's revenue. Seek to offer the borrower the size of loan that they need, rather than offering the maximum amount they qualify for.

☐ Responsible Credit Reporting

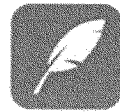
- Report loan repayment information to major credit bureaus and consult credit data when underwriting a loan. Such reporting enables other lenders to responsibly underwrite the borrower and helps the borrower build a credit profile that may facilitate access to more affordable loans in the future. Lenders must inform the borrower and any guarantors if they intend to report loan repayment performance to guarantors' credit bureaus only in certain circumstances, such as after a default.

The Right to Inclusive Credit Access

- ☐ Non-Discrimination
 - Respect the letter and intent of fair lending laws, including the Equal Credit Opportunity Act. Do not discriminate against small business owners on the basis of race, color, religion, national origin, sex, marital status, age, sexual orientation or identity, or any other protected class. Lesbian, Gay, Bisexual and Transgender (LGBT) small business owners deserve the same protection when seeking or obtaining credit.

The Right to Fair Collection Practices

- ☐ Fair Treatment
 - Abide by the spirit of the Fair Debt Collection Practices Act and provide borrowers similar protections as described in that Act.
- ☐ Responsible Oversight
 - Diligently vet and oversee the collections practices of third-party collectors and debt buyers.
 - Do not work with collectors or debt buyers who fail to treat borrowers fairly.
- ☐ Accurate Information
 - Transmit accurate, current, and complete information about the loan to third-party collectors and debt buyers.



SMALL BUSINESS BORROWERS' BILL OF RIGHTS

Small Business Borrowers' Bill of Rights (2.0 Update)

Attestation Form and Attestation Worksheet for Brokers

In order for a broker to become a signatory of the Small Business Borrower's Bill of Rights 2.0, its chief executive must attest that it abides by all practices described in the Small Business Borrowers' Bill of Rights by completing both the **Attestation Form** and the **Attestation Worksheet** below. Once completed, the documents should be emailed to info@responsiblebusinesslending.org.

Small Business Borrowers' Bill of Rights (2.0)
Attestation Form for Brokers

Summary of Attestation

By checking the boxes below, I affirm that my organization actively supports and adheres to the *Small Business Borrowers' Bill of Rights (2.0 Update)* and abides by all of the practices described in the attached Attestation Worksheet:

- ☐ The Right to Transparent Pricing and Terms
☐ The Right to Fair Treatment for Brokers
☐ The Right to Inclusive Credit Access

Note: You must be able to truthfully check all three boxes to be deemed a Signatory of the Small Business Borrowers' Bill of Rights and thereby eligible to have your organization's logo appear on the Small Business Borrowers' Bill of Rights website, www.ResponsibleBusinessLending.org.

Terms of this Attestation

- a. I have read and understand the *Small Business Borrowers' Bill of Rights (2.0 Update)*.
- b. I have completed the attached Attestation Worksheet, indicating in writing that my organization abides by *all* of the enumerated practices.
- c. By completing this Attestation Form and attesting that my organization abides by *all* of the enumerated practices in the attached Attestation Worksheet, I consent to having this Attestation Form and my organization's logo posted on the Small Business Borrowers' Bill of Rights Website.
- d. I understand that this Attestation Form and my organization's logo may be removed from the Small Business Borrowers' Bill of Rights website if my organization does not complete and submit a satisfactory updated Attestation Form within one calendar year from the date of my signature below, and each successive year thereafter, or if my organization ceases to abide by this Attestation.
- e. I agree, on behalf of my organization, that my organization assents to and will be bound by the Terms of Use for the Small Business Borrowers' Bill of Rights website.
- f. Anyone with questions for my organization regarding this Attestation Form completed by my organization can contact the following individual (include name, title, email address, and phone number):

- g. I attest that the information above is accurate and represents the standard practices for all financing products and services offered through my organization to small businesses. Furthermore, I hereby certify that I am authorized to sign this Attestation Form on behalf of my organization.

 Organization Name

 Chief Executive Signature

 Chief Executive Name

 Date

Small Business Borrowers' Bill of Rights (2.0 Update)

Attestation Worksheet for Brokers

In order for an organization to become a signatory it must attest that it abides by the Small Business Borrowers' Bill of Rights (2.0 Update) by having its chief executive complete this worksheet by checking each box below indicating that his or her organization abides by each of the practices set forth below.¹ Questions regarding the form can be directed to info@responsiblebusinesslending.org.

The Right to Transparent Pricing and Terms

- ☐ **Transparent Rate**
 - Disclose the Annual Percentage Rate (APR) and the annualized interest rate if one is used.
- ☐ The disclosure of APR is an addition of this 2.0 Update. The previous version of the Small Business Borrowers Bill of Rights required disclosure of annualized interest rates. An organization that is not already disclosing APRs may nonetheless complete this Attestation by checking this box, but must begin disclosing APRs as described here within 180 days of signing this Attestation. The organization agrees to provide evidence of disclosure of APRs within that time to info@responsiblebusinesslending.org.
 - Interest rate is defined as the scheduled or periodic financing cost, other than an upfront cost, expressed as a percentage of the outstanding principal and annualized.
 - APR is the annual rate that is charged for borrowing, expressed as a single percentage number. It includes fees as well as interest rate, and represents the actual yearly cost of funds.
 - Interest rates and APR are a percentage of outstanding principal balance, not of the original financing amount.
 - For lines of credit or other open-ended types of financing, rates must be calculated with reasonable assumptions about use, including assuming that the borrower draws the full amount on the origination date, and makes the minimum payments required.
 - If a rate is promotional or introductory, the term sheet or its equivalent should clearly state this, and how the rate could change in the future.
- ☐ **No Hidden Fees**
 - Disclose all upfront and scheduled charges.
- ☐ **Plain-English Terms**
 - Describe all key terms in an easy-to-understand manner, including the loan amount, total amount provided after deducting fees or charges, payment amount and frequency, total monthly payment amount if payment frequency is other than monthly, collateral requirements, and any prepayment charges.
- ☐ **Clear Comparison**
 - Present all of these pricing and other key terms clearly and prominently, in writing, to the borrower when the loan offer is summarized for the borrower and whenever a term sheet, offer summary, or equivalent is provided.

The Right to Fair Treatment from Brokers

- ☐ **Transparent loan Options**
 - Disclose all loan options for which the borrower qualifies through the broker's services, emphasizing the lowest APR option, and disclose all lenders to which the broker sends loan applications on the borrower's behalf.
- ☐ **Transparent Broker Fees**
 - Disclose all compensation paid to the broker, and all charges that will be paid directly or indirectly by the borrower, whether paid up front or financed in the loan.
- ☐ **Transparent Results**
 - Post clearly and prominently on the broker's website the anonymous and aggregated results of borrowers who obtain financing through the brokers' services, in terms of APR and financing product.
 - ☐ Please write here a URL for where this information can currently be found on your website, as of the date of signature:

An organization that is not already disclosing anonymous and aggregated results of borrowers who obtain financing through their services may nonetheless check this box, but must present evidence of this disclosure on its site along with the URL to info@responsiblebusinesslending.org within 180 days of signing this Attestation.
- ☐ **Empower Borrowers to Make Informed Financing Decision**
 - Educate the borrower on each loan option and ensure that the borrower reasonably understands the cost and terms as well as the pros and cons of financing decisions *before* they sign a loan document. Brokers should use tools that help the potential borrower comparison shop, including APRs and loan calculators.
- ☐ **Disclosure of Conflicts of Interest**
 - Disclose any conflicts of interest, the broker's fee structure, and any financial incentives they have, including whether the broker receives higher fees for brokering certain loans. Brokers who are paid higher fees with certain lenders, loan types, or terms other than the size of the loan, may not state they are acting in the best interest of the potential borrower.
- ☐ **No Fee for Failure**
 - No fees can be charged to the potential borrower if the broker is unable to find them a loan and if the borrower does not accept a loan secured through the broker's services.
- ☐ **Responsive Complaint Management**
 - If a complaint is submitted, provide a confirmation of receipt within five days and in writing, when possible, and research and resolve the complaint in a timely manner.

The Right to Inclusive Credit Access

☐ Non-Discrimination

- Respect the letter and intent of fair lending laws, including the Equal Credit Opportunity Act. Do not discriminate against small business owners on the basis of race, color, religion, national origin, sex, marital status, age, sexual orientation or identity, or any other protected class. Lesbian, Gay, Bisexual and Transgender (LGBT) small business owners deserve the same protection when seeking or obtaining credit.

¹ The term “loan” and related terms used here such as “lending” are intended to be interpreted in the broadest sense possible so as to include loans, lines of credit, merchant cash advances, and similar products offered and provided to U.S. small businesses, whether or not such credit products are characterized legally or otherwise as loans. Similarly, the terms “lender” and “borrower” are intended to be interpreted in the broadest sense possible so as to include, in the case of lenders, credit marketplaces that facilitate loans on behalf of lenders, cash advance providers, and all manner of persons providing loans to U.S. small businesses or evaluating the creditworthiness of such small businesses in connection with providing a loan, and, in the case of borrowers, all U.S. small businesses who seek or obtain a loan.

Signatories

The following lenders, brokers, and marketplaces have taken a stand for small businesses by attesting that they abide by the Small Business Borrowers' Bill of Rights.





BOND STREET

BORROWIZE



**BUSINESS CENTER
FOR NEW AMERICANS**



Small Business Finance



Capital for Opportunity and Change

CEDS COMMUNITY
ENTERPRISE
DEVELOPMENT
SERVICES

CITYFIRST
ENTERPRISES

► CAPITALIZING COMMUNITIES



**COLORADO
LENDING SOURCE**



Cooper
Lyle
Group



FastCapital360
Lightning Speed Business Funding Without the Hassle

 **finvoice**

FRESNO
CDFI

Financing Small Business
A subsidiary of
Fresno EOC

 **fundera**

 **Funding Circle**

 **funding societies | modalku**
Stronger SMEs, Stronger Societies

GROWTH
CAPITAL



Halo Business Finance



THE INTERSECT FUND

Small Business Borrowers' Bill of Rights – Signatories
November 2017



justine PETERSEN
BUILDING ASSETS. CHANGING LIVES.







QUOTE 2 FUND



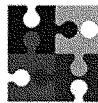
**STAUNTON CREATIVE
COMMUNITY FUND**



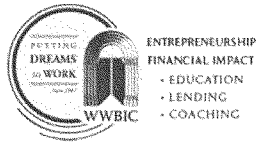
The
SUPPORT CENTER
Your Partner in Small Business Growth



Wacif

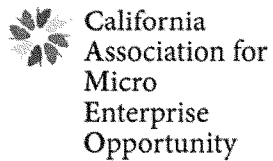


**Working
Solutions**

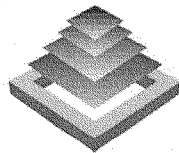


Endorsers

These organizations do not provide financing services to small businesses but care deeply about responsible business lending and actively support the Small Business Borrowers' Bill of Rights as endorsers.







national **CAPACD**
national coalition for
asian pacific american
community development



Small Business Borrowers' Bill of Rights – Endorsers
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OPPORTUNITYFINANCE ™
NETWORK

PROSPERITY
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