EXAMINING THE OPPORTUNITIES AND CHALLENGES WITH FINANCIAL TECHNOLOGY ("FIN TECH"): THE DEVELOPMENT OF ONLINE MARKETPLACE LENDING

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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EXAMINING THE OPPORTUNITIES AND CHALLENGES WITH FINANCIAL TECHNOLOGY ("FIN TECH"): THE DEVELOPMENT OF ONLINE MARKETPLACE LENDING

Tuesday, July 12, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Pearce, Posey, Fitzpatrick, Westmoreland, Luetkemeyer, Mulvaney, Pittenger, Barr, Rothfus, Guinta, Tipton, Williams, Emmer; Clay, Meeks, Scott, Velazquez, Sherman, Delaney, Heck, Sinema, and Vargas.

Also present: Representatives Hultgren and Hill.

Chairman NEUGEBAUER. The Subcommittee on Financial Institutions and Consumer Credit will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "Examining the Opportunities and Challenges with Financial Technology ('Fin Tech'): the Development of Online Marketplace Lending."

Before we begin, I would like to thank our witnesses for traveling here today to share their perspectives on this important issue. It is my understanding that we may be interrupted at some point for votes. I will alert everyone when votes are called, and I will recess the hearing so members may vote. We will then resume the hearing once votes are completed.

I ask unanimous consent that any member of the full Financial Services Committee who is not a member of the subcommittee be allowed to testify at the conclusion of the questioning by the subcommittee members.

I now recognize myself for 5 minutes to give an opening statement.

Today's hearing is focused on the development of online marketplace lending. It is the first in a series of hearings on financial technology or FinTech that I plan to convene in this subcommittee.

Online marketplace lending, sometimes referred to as peer-to-peer lending, has developed rapidly over the last decade. By leveraging technology, adding new lending platforms, and underwriting the logarithms, marketplace lenders have provided expanded avenues of credit for consumers and small businesses alike.

At the most basic level, online marketplace lenders provide borrowers with faster access to credit than brick and mortar lenders at loan levels traditionally not offered by banks. These lenders process these loans using online applications and automated underwriting that often allow funding decisions in less than 72 hours.

Many consumer-focused lenders specialize in certain segments of lending such as education loans, debt consolidation or personal loans. Small business lenders are able to work with businesses to address cash flow issues and provide capital for growth and expansion projects.

This type of financing is especially important given the depressed small dollar, small business lending since the financial crisis.

While certainly only a fraction of the $5 trillion in existing consumer debt, marketplace lending shows signs of tremendous growth potential and identifiable challenges.

Over the last year we have seen a growing attention paid to this market by Federal regulators, the media, and other market participants, for example, the Office of the Comptroller of the Currency, and the Treasury Department, who have considered the appropriate Federal regulatory framework for these lenders.

One proposal being considered would offer a limited national banking charter that could provide operational efficiency and regulatory clarity. To date I have appreciated the measured and thoughtful approach taken by the OCC and the Treasury on these issues.

Banks have grappled with the questions surrounding competitiveness and partnership. Some have been quick to point out an uneven regulatory structure while others have embraced the opportunity to partner with lenders to leverage their technology and consumer reach.

I am hopeful that our community financial institutions will benefit most from these technological advancements and partnerships. Market analysts and the media have closely examined and scrutinized the market's development and anticipated where new growth or consolidation might occur.

For example, there has been a significant shift from retail investor funding to institutional investor funding, which has facilitated the growth in originations. Some analysts estimate that the market will reach almost $90 billion by 2020.

The improvement of capital markets is also seen in the securitization process. The market saw its first securitization in 2013, and as of today there has been a cumulative securitization of $10.3 billion.

On the other hand, a 2016 report from Deloitte predicts that the future of the market will see large consolidations in strategic partnership with traditional banks.

To make better policy decisions it is incumbent upon us to understand the business models and the product offerings of these lenders, understand how banks and lenders compete and collaborate, and finally understand the current regulatory framework and how policy decisions may determine the market's future.

I hope today that members will walk away with a better understanding of the market, its participants, and where we are headed.

I will now recognize the gentleman from—

Mr. CLAY. Missouri.

Chairman NEUGEBAUER. —Georgia for—

Mr. CLAY. I have it.

Chairman NEUGEBAUER. Oh, Mr. Clay is here.

Mr. CLAY. I am here.

Chairman NEUGEBAUER. I'm sorry.

Mr. CLAY. I am here, Mr. Chairman. I'm sorry.

We are playing musical chairs today, but we will manage.

Chairman NEUGEBAUER. Yes. The ranking member is now recognized for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman, and thank you to each of our witnesses for their testimony today.

The promise of FinTech or marketplace lending is the ability to use innovation to improve upon the financial marketplace for the benefit of our stakeholders. That includes consumers and small business owners that have often been underserved by traditional institutions in the financial services sector.

At the end of the day, all of America benefits when our financial system ensures that access to responsible credit is nondiscriminatory, transparent and safe for business and individual consumers.

Maintaining that type of financial system should also be our priority when thinking about marketplace lending. That means that FinTech or marketplace lending consumers must have clear access to transparent information about the products that they are receiving.

That means that marketplace lenders also need to be transparent about their use of alternative data, provide consumers with the means for challenging the accuracy of that data, and ensure that the data does not discriminate against consumers based on protected characteristics.

It means that FinTech investors must be provided with accurate info on the quality of the loans that they are investing in and the associated credit risk.

And finally, that means that marketplace lending or FinTech cannot ignore the credit and capital needs of communities of color and women and minority-owned businesses.

Innovation is important and I applaud the marketplace lending sector for using innovation to expand the suite of financial products and services available to consumers. Going forward, it is my hope that your innovation will also extend to improving access to credit for underserved consumers as well.

Thank you again to each of today's witnesses and I look forward to your testimony.

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

Chairman NEUGEBAUER. I now recognize the gentleman from Georgia, Mr. Scott, for 2 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, and appreciate this opportunity to give an opening statement. I think that this new area of the financial system interacting with our rapidly changing technology is not only one of the more fascinating aspects of our economy but is very definitively the future.

We need not look any further than our last retail statistics where I think in the last I think it was 8 days before the Christmas holidays, 62 percent of all of the retail activity happened online. It is sort of like now we have the future right in our hands with the BlackBerry.

And with this comes a lot of innovations and it is important to me and to the State of Georgia because this is one of the fastest and growing industries in the State of Georgia and also because right now we have 71 million unbanked or under banked individuals in our system.

And we have to make sure that they have access to credit. And we also want to make sure with the rapid innovations and the technological changes that are happening that we move with caution to make sure that our policies that we put forward are neither overreaching nor under reaching but that we reach that delicate balance.

So Mr. Chairman, I really look forward to this hearing and with that I will yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentleman.

Today, we welcome the testimony of Mr. Parris Sanz. He is the chief legal officer of CAN Capital, testifying on behalf of the Electronic Transactions Association.

Mr. Sachin Adarkar is the general counsel and chief compliance officer for Prosper Marketplace.

Mr. Rob Nichols is the president and CEO of the American Bankers Association.

Mr. Bimal Patel is a partner of the law firm O'Melveny & Myers.

And Ms. Gerron Levi is the director of policy and government affairs at the National Community Reinvestment Coalition.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, each of your written statements will be made a part of the record.

Mr. Sanz, you are now recognized for 5 minutes.

STATEMENT OF PARRIS SANZ, CHIEF LEGAL OFFICER, CAN CAPITAL INC., ON BEHALF OF THE ELECTRONIC TRANSACTIONS ASSOCIATION

Mr. SANZ. Thank you, Chairman Neugebauer, Ranking Member Clay, and members of this subcommittee. Thank you very much for inviting me here today at this important hearing regarding the opportunities and challenges regarding online and marketplace lending.

My name is Parris Sanz. I am the chief legal officer of CAN Capital. I am testifying here today on behalf of my company as well as the Electronic Transactions Association, the leading trade association in the payments industry, of which we are a member.

CAN Capital was founded in 1998 by a woman small-business owner. She struggled to access commercial loan products that would address her seasonal cash flow needs. And when she was unable to do so, she made it her cause to solve the issue of access to credit for small businesses.

Now, some 18 years later, CAN Capital has the longest operating history in this space. Our risk and underwriting models have been tested and proven during the previous credit crisis, and we have provided small businesses with access to over $6 billion.

We have served hundreds of different industries across the United States from medical practices to restaurants to automotive shops. The proceeds of our products are used for business purposes like hiring new employees, purchasing new equipment and managing cash flow.

As we all know, small businesses are the backbone of our economy. They account for half of the total workforce and over the last 20 years they accounted for two of the three net new jobs in the country.

But despite their importance to our economy, these small businesses struggle to obtain the capital that they need to sustain and grow their businesses, especially since the Great Recession.

In major surveys, small business owners report that they are often unable to access the capital they need through traditional small business loans. Part of the problem is that traditional financial institutions face high costs to originate these small business loans.

It can cost as much for a bank or other financial institution to originate a $100,000 loan as to originate a loan for $1 million to $3 million, making it uneconomical for these institutions to provide access to these small dollar loans.

This creates an acute problem for Main Street because loans of $100,000 and less account for 90 percent of all small business loans. Fortunately for our country's underserved small businesses, new and innovative technology platforms are presenting alternatives to traditional small business loans and expanding access to capital.

Online lending platforms like CAN Capital provide small businesses with fast and easy access to the loans they are seeking. Loans of $100,000 and less and loans of shorter duration that are often better suited to the operating needs of small businesses.

With the help of our data-driven algorithms to assess the financial strength of potential borrowers, CAN Capital enables fast funding decisions in minutes and can deliver capital the same day or the next day.

Our industry's approach to evaluating risk has expanded access to many underserved small businesses. This is because companies like CAN Capital use data-driven underwriting models that assess the financial strength of the business itself as opposed to focusing solely on the FICO score of the business owner.

As a result, we have been able to safely make available capital to many underserved small businesses that would typically be overlooked by traditional financial institutions simply because of a low FICO score on the part of the business owner.

As the committee begins to evaluate the regulatory framework of our industry, we ask you to be sensitive to the risks that additional regulation of non-bank platforms could stifle innovation and possibly roll back the access to capital the platforms like CAN Capital have provided.

Contrary to claims that online small business lending is unregulated, the industry is subject to multiple layers of Federal and state regulation. Also, companies like CAN Capital that partner with banks become subject to a significant amount of additional regulation and supervision, both by the Federal banking agencies that oversee the bank as well as by the bank itself.

Any additional regulation beyond this would certainly risk restricting small businesses' access to much needed capital. Instead, we urge policymakers to facilitate further innovation in the small business lending space through a number of means.

Encourage online platforms to participate in Federal programs such as the loan guarantee program of the SBA. Encourage referral partnerships between online lending programs and traditional financial institutions to expand access to capital to deserving small businesses.

Encourage industry self-regulatory efforts with respect to loan disclosures and borrowers' rights. And finally support initiatives to create a harmonized policy framework that streamlines existing state laws for online lending.

I would also like to note that our industry and the small business community we serve are especially concerned about calls by some public officials to regulate small business loans in the same way as consumer loans.

Commercial loans consistently have been regulated differently than consumer loans for multiple reasons, including the role of commercial credit as a driver of the economy and the sophistication of the users.

As part of a thoughtful analysis, we ask policymakers to carefully study the important differences between commercial and consumer lending before making any decisions to conflate these vastly different categories.

We applaud Chairman Neugebauer, Ranking Member Clay, Small Business Committee Chairman Chabot and other Members of Congress who have pushed back against these efforts in a recent letter to Treasury Secretary Liu.

On behalf of the thousands of small businesses that we serve, we ask other Members of Congress to please do the same.

I thank the committee for the opportunity to testify and I look forward to answering your questions. Thank you.

[The prepared statement of Mr. Sanz can be found on page 75 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Adarkar, you are now recognized for 5 minutes.

STATEMENT OF SACHIN ADARKAR, GENERAL COUNSEL AND CHIEF COMPLIANCE OFFICER, PROSPER MARKETPLACE

Mr. ADARKAR. Good afternoon, Chairman Neugebauer, Ranking Member Clay, and members of the subcommittee. My name is Sachin Adarkar. I am the general counsel and chief compliance officer of Prosper Marketplace. And I am honored to be here today representing Prosper.

Prosper Marketplace launched in 2006 as the first U.S. marketplace lending platform. Our proprietary online platform connects borrowers looking for unsecured loans with individuals and institutions who wish to invest in those loans.

To date more than $6 billion in loans have been funded through the Prosper platform. The loans help people refinance high interest credit card debt or pay for large expenditures such as medical bills.

All the loans originated through the Prosper platform are made by WebBank, an FDIC-insured industrial bank under a credit policy approved by WebBank's board of directors. Prosper services all of the loans made through the platform.

Prosper is the second largest consumer marketplace lending platform in the United States. Some marketplace lending platforms, such as Prosper, offer investors the opportunity to invest in the loans made through the platform, while other platforms retain those loans and hold them on their balance sheet as investments.

The Prosper platform offers borrowers access to fixed rate consumer loans ranging from $2,000 to $35,000 with 3-year and 5-year terms. We facilitate a fast and transparent loan origination process that includes clear disclosures of all costs and fees and access to competitive interest rates.

The minimum FICO score for eligibility on our platform is 640, and the average FICO score is 705. The most common reason for taking out a loan on our platform is to refinance unsecured—I am sorry—to refinance existing unsecured debt such as on a credit card at a lower interest rate and on more affordable terms.

Prosper uses mostly automated processes to verify the identity of borrowers and assess their credit risk. We have developed innovative technology to make these processes more efficient and effective.

For investors, the Prosper platform offers access to an attractive asset class with steady cash flows and consistent returns. The estimated weighted average return on loans originated through our platform in June 2016 is just above 7.4 percent.

In order to help investors make well-informed decisions we provide them with a high level of transparency. At the time an investor is considering investing in a loan or a related security, we provide them with detailed but anonymized data regarding the borrower's credit characteristics.

After an investor has purchased a loan or a security, we also provide them with detailed performance data regarding the loan on an ongoing basis. We believe this approach creates an open and fair process for all participants in our marketplace.

Loans originated through the Prosper platform are subject to the same comprehensive regulatory framework as loans originated through any traditional consumer lending platform. All loans must comply with the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Patriot Act, and a host of additional laws and regulations.

The loan program is subject to direct regulatory oversight by WebBanks' regulators, the FDIC and the Utah Department of Financial Institutions. The FDIC also has direct examination and enforcement authority over Prosper under the Bank Service Company Act.

Additionally, Prosper is subject to the enforcement authority of the CFPB and the examination and supervisory authority of numerous state licensing bodies. Finally, the retail portion of our investor offering is subject to oversight by the SEC, as well as State securities regulators.

We have developed a robust compliance management program that includes strong controls, policies and procedures and governance for all aspects of our operations. We are proactive in raising issues of potential concern with regulators. And we are committed to continuing this open and transparent dialogue going forward.

We recently joined with other leading marketplace lending platforms to form the Marketplace Lending Association, which aims to facilitate this dialogue and encourage the responsible growth of our industry.

We believe Marketplace Lending brings significant value to both borrowers and investors and that it will play an increasingly important part in the financial industry in years to come.

I want to thank you for this opportunity to provide an overview of our business and industry and I welcome future opportunities to discuss these issues. Thank you.

[The prepared statement of Mr. Adarkar can be found on page 42 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Nichols, you are now recognized for 5 minutes.

STATEMENT OF ROB NICHOLS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION

Mr. NICHOLS. Thank you, Mr. Chairman, and Ranking Member Clay. My name is Rob Nichols, and I am the president and CEO of the American Bankers Association. The topic of your hearing, Mr. Chairman, is a very timely one.

New technologies are quickly changing the way businesses connect with consumers. FinTech is a term used to capture this rapid convergence of banking and technology.

While it has been used to refer to tech-focused startups, innovative technologies are offered by banks and startups alike.

While these technologies may feel new, at their core they are leveraging technology to deliver traditional banking products and services.

Make no mistake. Banks are pro innovation, pro consumer and very technology-focused. Banks have pioneered ATMs, credit cards, online banking, remote check deposit, et cetera.

Banks continue this innovation today, investing billions of dollars annually to bring their customers the latest technology apps delivered through secure and trusted channels. One such product, for example, was developed by a mutual bank in New England that recently announced its express business loan, which allows small businesses to apply for a loan, get approval and receive funding, all online and in less than 3 minutes.

Banks have a long history of course of serving customer needs and have established entrusted relationships. These relationships are backed by a culture of compliance and regulatory oversight that ensures customers are protected. When innovative products are delivered through bank channels, customers get a great experience backed by a relationship they can trust.

In addition, banks are actively partnering with FinTech startups to bring their customers the latest technologies. When banks innovate with startups, customers win. This is why the banking industry supports policies that empower banks and enable them to innovate and enable them to partner.

If they are better able to integrate these technologies, customers will have greater access to safe, innovative financial services.

One way to facilitate this is to offer banks and startups a safe place to innovate new products. This program, often referred to as a sandbox or a greenhouse, would allow banks and startups to test real world products that otherwise they would not be able to offer.

Importantly, while the same rules typically apply to banks and non-banks alike, a lack of proactive oversight and supervision can mean that customers may receive inconsistent treatment from non-banks. Some have advocated adding consumer protections to small business loans to address this.

We believe a better approach is to focus on the differences between the two that lead to very different outcomes, namely oversight. Problems that are emerging in the small percentage of online loans should not drive radical and unnecessary changes that risk impairing a market that has served businesses well for decades, like this gentleman made.

Regulators are currently examining the potential of a Federal FinTech charter to address this lack of oversight. As they examine this issue we urge them to consider how any such charter would differ from a bank charter and ensure that it provides customers bank level protections.

It is important to note that while technology can drive innovation and add value, it is not the replacement for a community presence. Community banking is a relationship business that is not replicable by technology.

While banks are driving technological innovation, they remain invisible presence supporting their local communities as they always have through community outreach and countless hours of volunteering, something that cannot be done through a keystroke or an algorithm.

FinTech technologies present tremendous opportunities for banks and customers alike. They have the potential to promote financial inclusion, giving greater access to financial services on better terms.

These benefits though are only possible if we empower banks to innovate and partner with startups. The banks' investment in innovation today has the potential to benefit customers and businesses now and for many, many years to come. These innovations will only add value if banks, startups and regulators can collaborate.

Mr. Chairman and ranking member, the ABA stands ready to work with Congress and regulators to help make this happen. Thank you very much for holding this hearing.

[The prepared statement of Mr. Nichols can be found on page 54 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Patel, you are now recognized for 5 minutes.

STATEMENT OF BIMAL PATEL, PARTNER, O'MELVENY & MYERS LLP

Mr. PATEL. Chairman Neugebauer, Ranking Member Clay, and members of the subcommittee, thank you for the opportunity to appear and to testify before you about the development of online marketplace lending.

My name is Bimal Patel. I am a partner and the head of financial advisory and regulation practice at O'Melveny & Myers, and was formerly for 3 years a senior executive at the FDIC before I rejoined O'Melveny.

Since returning to private law practice I have advised marketplace lending platforms, banks and investors on commercial and regulatory issues in this industry.

According to the Treasury Department in its recent white paper on online marketplace lending, and I am quoting now, "Online marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers."

Within this broad framework, marketplace lending business models vary considerably, focusing on different consumer segments with different operational and underwriting models.

The online marketplace lending industry is growing rapidly. According to date reported by the California Department of Business Oversight, the aggregate volume of loan originations made by 13 of the largest online lenders grew from just under $2 billion in 2010 to just under $16 billion in 2014, which is an increase of 699.5 percent.

While their business models and target customer segments can vary significantly, many online marketplace lenders share some common characteristics, including a user friendly online experience, a non-traditional services funding, a balance sheet light economic model, and alternative credit decision algorithms.

Despite the industry's growth, it still constitutes a very small percentage of the U.S. credit markets which encompass several trillion dollars. Thus, there appears to be substantial opportunity for the industry to grow.

One key point of distinction within marketplace lending models centers on whether a particular marketplace lender partners with a bank in its origination process. Federal law currently permits banks to export their home state rate of interest to all borrowers regardless of the state in which a borrower resides.

Consequently loans originated by banks whose home States have no effective usury limitation, a limitation on maximum interest rates, can carry higher interest rates than loans originated by other banks and non-bank lenders. Thus, some marketplace lending models depend on such a partnership to enable them to underwrite loans at rates that would otherwise violate state usury laws.

As an alternative to partnering with a funding bank, marketplace lenders can engage in lending by procuring state lending licenses in which they make loans, but these loans are subject to state law interest rate restrictions that vary by state and impose administrative and financial burdens that can be prohibitive to certain business models.

Depending on the precise business model of a marketplace lender in the category of borrower to which it caters, a series of consumer protection data privacy, securities and anti-money laundering laws that I have identified in my written testimony, are generally applicable to lenders either directly or indirectly through bank partners.

Recent developments also indicate that the prudential banking regulators, CFPB and state regulators and taking a keen interest in this area and that further regulatory developments are forthcoming.

As I mentioned previously, there appears to be substantial opportunity for this industry to expand and to further economic growth and economic opportunity for U.S. consumers and businesses.

This growth will be dependent on economic and commercial considerations as well as State and Federal policy developments. I thank the committee for taking an interest in these important issues and I welcome your questions.

[The prepared statement of Mr. Patel can be found on page 63 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And now Ms. Levi, you are recognized for 5 minutes.

STATEMENT OF GERRON S. LEVI, DIRECTOR OF POLICY & GOVERNMENT AFFAIRS, NATIONAL COMMUNITY REINVESTMENT COALITION

Ms. LEVI. At the outset, I want to thank you, Mr. Chairman for convening this important hearing. Marketplace lending models certainly warrant closer examination and some congressional oversight.

And Ranking Member Clay and others on the committee, I know you will be asking important questions about how marketplace lending models interface with the Nation's traditional banking infrastructure.

Our marketplace lenders who are largely monoline financial service providers structures in ways that will ensure that they are resilient throughout business and economic cycles.

What is the nature of Federal supervisory and examination protocols regarding consumer protections and fair lending laws and regulations? Whether interest across the various models are aligned so that FinTech players have the veritable skin in the game so that they have a stake in ensuring that loans are underwritten well, ability to repay is paramount, and lending is safe and sound.

Importantly, we believe that all the members of the committee examine whether aspects of the industry's use of data, sophisticated but opaque proprietary underwriting algorithms, still insufficient transparency around pricing and loan terms, broker fee and compensation arrangements and other features are invoking parallels to the run up to the crises around predatory subprime lending and private label securitization.

My name is Gerron Levi. I am the director of Policy and Government affairs at the National Community Reinvestment Coalition. NCRC and our 600 grassroots members quite simply are interested in creating opportunities for people to build wealth.

We work with community leaders, policymakers and financial institutions to champion fairness in banking, housing and business development. I appreciate the opportunity to testify this afternoon.

Though the industry is nascent, marketplace lending is a growing segment. When evaluating these online lending platforms and their sophisticated underwriting algorithms, NCRC certainly is interested in seeing how they can expand safe and sustainable credit. There is no doubt that innovative solutions are needed to address a fundamental issue.

Small business lending is down and businesses are not getting off the ground or are dying on the vine for a lack of credit.

According to a recent Wall Street Journal report, the number of loans issued by 10 of the largest banks in the United States has decreased 38 percent to $44.7 billion in 2014, which is down from a peak of $72.5 billion in 2006.

Importantly, however, we want to see FinTech and all innovation and marketplace lending that is safe and sustainable.

Consumer protections and fair lending protections should not be different for the borrower based on where they apply for the loan. We have also long supported all lenders in the marketplace, including marketplace lenders, being covered by and examined under the Community Reinvestment Act so that low and moderate income borrowers and underserved communities, including rural communities, are receiving the full benefit of lending and innovation in the financial marketplace.

We have grown concerned about some of the dissatisfaction reports we are seeing in the marketplace from our members and others. A recent survey of small businesses by several Federal Reserve banks reveals that 20 percent of small businesses obtaining credit used online lenders with micro businesses using them to a greater extent.

But their satisfaction with online lenders was very low. Online lenders received a score of 15 among firms approved for credit compared to 75 for small banks and 51 for large banks. Small business lenders complained about the lack of transparency, the unfavorable payment terms and very high interest rates.

I cover a number of things in my written testimony, but among the concerns that we have are around data and transparency. We think similar to the Home Mortgage Disclosure Act not the mortgage lending side, Section 1071 of Dodd-Frank presents a great opportunity for marketplace lenders to publicly disseminate data on their small business lending activities, afford consumer protection and fair lending reasons.

Let me just conclude by raising the issue that one of the other panelists raised around limited purpose charters for FinTech. We do have some concerns around that. We do want to see CRA extended in the case of limited purpose charters.

We also want to make sure that retail lending done by marketplace lenders are examined under those charters. We just have concerns about whether that is appropriate in this instance before the great benefits of national charters are extended to these type of platforms, Federal pre-emption, access to the payment system. There are tremendous benefits from charters being extended and want to make sure that fair lending and consumer protections are extended in the process, and CRA.

Thank you very much for the opportunity to testify and I welcome your questions.

[The prepared statement of Ms. Levi can be found on page 45 of the appendix.]

Chairman NEUGEBAUER. I thank the gentlewoman.

The Chair now recognizes himself for 5 minutes for questioning.

So this is an educational hearing and so to kind of set the platform here, Mr. Adarkar, can you walk me through a typical loan from application to securitization so we kind of get a picture of what this playing field looks like?

Mr. ADARKAR. Absolutely. So the average loan on our platform—all the loans made through our platform are unsecured consumer loans. The typical loan size is around $13,000 and the typical interest rate is 13.9 percent.

So the way the process works is we market to potential borrowers through a number of sources. We send out direct mail pieces. We do email advertising. We do buy search words on Google. We also have some website partners who have comparative financial information sites.

There are a number of places through which borrowers come to us.

Once they come onto the website there is an online application process through which between the information they provide and the information we pull from their credit report, we can instantaneously make a decision for them about whether they qualify for credit and the terms on which they qualify.

We present them with the terms that are available to them if they are eligible, and if they decide to move forward then there is sort of a two-track process that happens. On one track we then essentially post the terms of their loan application through our website with all personal information anonymized.

And the investor members on our website can essentially make a commitment about whether this particular loan is one that they are interested in. This is something that is available to both retail and institutional investors.

These days the demand is such on our platform that most of these requests are essentially fully funded instantaneously. So the sort of funding track is one part of the process.

A second thing that is happening simultaneously is this sort of verification process which consists of a few components. The first thing is we need to verify the identity of each applicant to confirm identity fraud isn't involved.

We also have a risk-weighted employment and income verification process just to confirm the key information related to their application to the extent that incorrect information either in the credit report or supplied by the borrower might increase the risk of default to an unacceptable degree.

So that verification process is happening at the same time. And it typically takes from between 3 and 5 days. So once that process is completed, once we have verified the borrower information and we are ready to fund the loan, once we have received commitments from investors to fund the loan, then WebBank, who I mentioned is the bank partner that makes the loans originated through the platform, they fund the loans to the borrower out of their funds.

The borrower receives the funds and 2 business days after the loan is originated WebBank sells the loans to Prosper. We then resell the loans to our investors.

For institutional investors, they buy the entire loan outright. For retail investors, we break the loans into pieces and sell pieces of each loan to a group of retail investors which allows a broader range of folks to participate in the inv process.

Chairman NEUGEBAUER. So in that 2-day period between the time you fund the loan and you securitize or you bring your institutional investor in, you warehouse that loan for 2 days?

Mr. ADARKAR. During that 2-day period it is actually WebBank that retains ownership of the loan. They then sell it to us and we turn around and resell it to our investors.

As soon as the loan is originated then we are responsible for servicing the loans, meaning we are the ones collecting payments from the borrowers, providing the borrower's information, passing those payments on to our investors, as well as providing our investors with regular proof of the loans.

Chairman NEUGEBAUER. Thank you.

Mr. Nichols, how do you envision—I think you speak to this a little bit in your written testimony, but how do you envision marketplace lending kind of changing the environment in the more traditional banking space?

Mr. NICHOLS. Mr. Chairman, as I said, our overall view on this is we think partnerships are fantastic and a good opportunity for both. I would say though I am optimistic about the future of community banking because of that personal touch.

You have banks that have been operating in communities for decades. It is also good to have a bank that specializes in small business lending so that you can look someone in the eye and get a sense of what the business plan looks like.

But I do think as a general observation community banks particularly, Mr. Chairman, can really benefit from a lot of these FinTech partnership opportunities, a lot of the larger banks have billions in R&D budgets and in laboratories and they are doing lots of work.

They don't need as much assistance frankly as the community banks do. I think I may have shared this with you, but we have started a task force, Mr. Chairman, at the ABA, to really focus on this issue.

And we have dealt with not only experts within the ABA and in the banking sector but have really fanned out across the United States to meet with folks all over the United States and even probably talked to some international participants to try to find ways where we can specifically help the U.S. community bank market partner with FinTech companies to better serve their clients and customers.

And the recommendations, Mr. Chairman, of that task force will be out in the weeks ahead.

Chairman NEUGEBAUER. I thank the gentleman.

Now, I recognize the ranking member of the subcommittee, Mr. Clay from Missouri, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Sanz, a number of marketplace lenders have opted to operate under the Small Business Borrowers Bill of Rights because they were concerned about the complaints that small businesses have been raising about marketplace lending practices.

That bill of rights includes a commitment to disclose annualized interest rates or APR so that small business owners have a legitimate basis for comparing loan products, but CAN Capital did not opt into the Small Business Borrowers Bill of Rights. Does CAN Capital disclose annualized interest rates or APRs to your small business borrowers?

Mr. SANZ. Congressman Clay, thank you for your question. We did not join the Borrower Bill of Rights group initially out of a number of concerns with what that set of principles was capable of achieving and not achieving.

Certainly a lot of respect for the intent and impetus behind that group, but candidly, I don't know if Congress Members are aware but that bill of rights is selective in terms of the ones that you can sign up for.

It is not like 10 commandments where you have to abide by them all. And CAN Capital had some concern about the teeth behind it and really was much more focused on trying to do something really palpable and meaningful.

And so alternatively we, with Cabbage and Onda Capital formed the Innovative Lending Platform Association. And we are currently sponsoring the SMART Box initiative. SMART is an acronym that stands for Smart Metrics About Rate and Total Cost.

The concept of total cost candidly is what we have learned in our 18 years of experience is the most meaningful cost metric to small businesses. Small business owners are very focused on maximizing their return on investment. They are focused on the ROI that they will obtain from the use of proceeds.

And in our history we have determined that they really base their decisions on the total cost of capital, which is information that we provide on all the capital products.

Mr. CLAY. But you—wait a minute. Wait a minute now. I am not going to let you filibuster my question. What are your annual interest rates?

Mr. SANZ. Many of our products don't involve interest and don't have an APR associated with them, but maybe to more directly answer your question, through the aisle PA and through the SMART Box initiative we will be disclosing APRs around all products.

Mr. CLAY. Okay.

Mr. SANZ. The initiative is to create a standardized disclosure mechanism.

Mr. CLAY. Okay. Okay. What was the main APR of the loans that you provided to small businesses last year?

Mr. SANZ. I couldn't tell you that off the top. I would have to get back to you with that information.

Mr. CLAY. Okay. Don't you think that having objective and comparable information is essential to empowering small business owners to decide which financial products are best for them?

Mr. SANZ. Oh, absolutely, sir, but I would argue that there may be the assumption oftentimes made that APR is the only means of delivering pricing transparency. And what we would tell you from 18 years of operating in the small business finance space is that total cost of capital is a much more meaningful financial metric for our customers. And we disclose that clearly and—

Mr. CLAY. Okay.

Mr. SANZ. —conspicuously.

Mr. CLAY. All right.

Mr. SANZ. And we will also disclose APR though the SMART Box.

Mr. CLAY. I am sure that other members will have questions for you.

Let me go to Ms. Levi. FinTech advocates have pointed to marketplace lending as a vehicle for expanding access to credit for traditionally underserved communities, yet the Department of Treasury report found that virtually none of the loans being made by marketplace lenders were going to the underserved communities of color and low and moderate income communities.

Do you think that marketplace lenders are meeting the credit and capital needs of minority communities and other underserved groups?

Ms. LEVI. I really—there are a couple of ways to answer that. First of all, this is one of our issues. We really don't have enough data about how the market is operating.

What I will—so in the same sense that you have home mortgage, the Home Mortgage Disclosure Act publicly available information about mortgages and who they are going to, on the marketplace lending side and just really small business lending more broadly we do not have that kind of comprehensive data.

Now, section 1071 of the Dodd-Frank Act does present an opportunity to get that data, that marketplace lenders should be covered. Just preliminarily I would say that marketplace lenders from our evidence and from some of their annual report, like annual reports like Lending Club, are servicing prime customers, folks with 640 credit score or above.

But it certainly is an issue that would need more information.

I will also say that one of our members, Woodstock Institute, did a review of online lenders and found for, for example, CAN Capital effective interest rates of between 36 percent and 60 percent as to your question, your last question.

Mr. CLAY. Okay. I am glad someone could answer my question. Thank you, Ms. Levi.

And I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from New Mexico, the vice chairman of the subcommittee, Mr. Pearce, is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. SANZ, I think you mentioned that you all have about $5 billion more or less in loan transactions. Do you evaluate where your market share is coming from? Is it new loans that might not have been served or—I am thinking about Ms. Levi's observations that she is seeing our businesses die on the vine. We are seeing the same thing in New Mexico. So you are going out harvesting new or are you pulling market share from someone else?

Mr. SANZ. There is some of both, but definitely a significant portion of the small business market that is underserved by traditional financial institutions.

So just to clarify one metric, with respect to the $6 billion of capital to which we have provided access, some portion of that is in the form of loans.

Another portion is in the form of a purchase of receivables. It is a true sales transaction. It doesn't entail interest and that is probably some of the complexity that I was struggling to get to answer Congressman Clay.

Mr. PEARCE. Okay.

Mr. SANZ. That being said, our model was designed—

Mr. PEARCE. With all due respect, I just wanted an answer to the one narrow question. I have several more to ask, so I appreciate the answer.

Mr. Adarkar, you seemed to have thought about the process quite a lot. Where do you see some of the greatest likelihoods of abuse in this system, high tech system of quick looks? Where are the—just to help us evaluate that if you would?

Mr. ADARKAR. The potential for abuse in terms of fraud is something that we take very seriously and we actually feel—

Mr. PEARCE. No, I am not asking for your feeling on it. What are the greatest risks? Where will they originate from? Because I have some in my mind and I will ask about them if you would rather, but I want to know. You are more a specialist than me.

So I am sitting here looking and so the news report today says things that my car is telling the car dealers about me. In other words, you have access to information and so among that information you would know my tendency that if I will buy a product or if I will take a loan at this rate then why would you give me a better loan?

You would fit it there. Do you see that manipulation of data that I think most Americans are frightened by?

Mr. ADARKAR. I don't see that as being a risk on our platform.

Mr. PEARCE. How about you, Ms. Levi? Do you see that as being a problem? You are talking about loans in the nature of 36 percent, which seems a little bit above the market rate, so do the people you advocate see that as being a potential problem that they access the information on the part of very fast financial analyses would give insights that might affect the rates or how or when or how long?

Ms. LEVI. Yes, and I assume you are talking about the information that the lender is receiving and inputting into their algorithms to make the lending—

Mr. PEARCE. Yes, the CFPB is right now taking information on every human being, 300 million people in the United States. And if a lender has access to my buying habits then they can tell everything about me. They know what political party I am in. They know who I am going to vote for in the next election.

They know what I buy. They know what I will pay for it. Everything, and that is very unsettling that lenders would come into that.

Mr. Nichols, you are saying that the banks are glad and willing partners and that is reassuring because typically I look at the local people as being the connect to keep the abuses out of a system.

Tell me if you are contemplating these possibilities of just vast amounts of information being fed to you without even your knowledge? I don't know. I am just looking for where the system can go wrong and where it needs to be looked at.

Mr. NICHOLS. I would just say, Congressman, as a general observation this issue of protection of data is so, so important in our new marketplace with all the rogue actors out there, with breaches, with cyber. You read about it every single day.

So this issue of keeping customer data protected is a critically important aspect of the exercise of any partnership with any type of company—

Mr. PEARCE. I understand that, but still you see Facebook and they would pull down posts by conservatives. They took a political bent and so even though you have the desire to protect, you still have the Snowdens out there. You still have somebody who will sell every single bit of information they get.

You get hacking into the system. And I for one see dramatic possibilities in the marketplace that we are discussing, but I also see some risks. So I don't know.

Ms. Levi, do you talk about businesses dying on the vine. Do you go to those businesses and say hey, there is no platform out here? Do you ever one-on-one talk to people and say there might be another opportunity. Don't die. Because again, that is a problem we face in New Mexico since CFPB is really clamping down many people are just not lending as much.

Ms. LEVI. Yes. We do interface with small businesses through some of our business centers in providing technical advice, counseling them on how to procure safe and sustainable credit. Absolutely.

Mr. PEARCE. Okay. All right. Thanks.

I will yield back to the chairman.

Chairman NEUGEBAUER. I have been advised the votes have started. We are going to go to the gentleman from Georgia, Mr. Scott, for his questioning and then we are going to recess. I think we have five votes and then we will reconvene.

Mr. Scott, you are recognized for 5 minutes.

Mr. SCOTT. All right. Thank you.

As we all know with this rapidly changing technology, consumer protection is even more extremely vital regardless of where the loan is issued, either in the bank or even online.

And what I am gathering from the testimony I am hearing from one side that this new online marketplace lending is covered by adequate regulations for consumer protections. But then on the other side I am hearing that they aren't enough.

So Mr. Nichols, let me ask you and Mr. Adarkar, on what you think are the differences in the type of consumer protection provided by banks versus the type that is provided by a FinTech company?

Mr. NICHOLS. Sir, there is really one big delta. As the gentleman articulated, all the laws that they are subject to, that is correct. The difference is oversight.

Mr. SCOTT. Yes.

Mr. NICHOLS. Because of the supervisory relationship that all these banking regulators have with banks, it is the oversight relationship. That is key.

Mr. SCOTT. Let me ask you, Mr. Nichols, if you would explain thoroughly so that I would understand. When you speak oversight give us an example so we can be clear.

Mr. NICHOLS. The relationship, the FDIC, the Fed, the OCC, all these entities have with U.S. banks they have visibility into what the banks are doing in terms of cyber, honoring people's privacy, their data, looking at the safety and the soundness of the institution, looking at systemic risk.

The oversight model of the U.S. banking sector is quite defined.

Mr. SCOTT. Yes.

Mr. NICHOLS. That is the big delta at this moment, and that is what I know the OCC is thinking about in terms of if there is going to be a non-bank charter. This is the sort of issue that they are grappling with is the oversight delta.

That is the key difference between the two.

Mr. SCOTT. Mr. Adarkar, do you concur?

Mr. ADARKAR. Sure. I would just add that the CFPB has the same enforcement authority with respect to marketplace lenders as it does with respect to banks, just two additional points. For all marketplace lenders they are either operating in partnerships with banks to originate their loans or originating directly.

As I mentioned, if they are partnering with banks then they are subject to the supervisory and examination authority of the banks under the Bank Services Company Act. If they are lending directly then they are subject to the state licensing and oversight requirements of all the States in which they are lending and they are subject to examination and supervision by the licensing bodies of those States.

Mr. SCOTT. Okay. Let me ask the panelists about our small businesses. This is the backbone of our American economy and data clearly demonstrates that lending to these critical drivers of our Nation's economy is still struggling to rebound from the post-recession.

So when I saw Treasury, if you recall, the May 2016 white paper, drawing the conclusion that micro business loans, meaning any loan to a small business of $100,000, shared the same characteristics as consumer loans and then suggested that such loans should be subject to the same consumer protections.

It got me to thinking what is the real distinction between these loans? If we hold these micro business loans to the same standards as consumer loans, what impact is that going to have on businesses gaining access to capital?

Ms. LEVI. I do want to just briefly hit on the examination issue. There are several marketplace lending models and whereas traditional banks do come under an examination protocol, bank examiners go onsite. They examine their lending under CRA they examine their lending.

Marketplace lenders do not have that level of rigor in terms of examination protocol. And you really have to look at the various models to determine.

They may be subject to the law, but whether their actual lending, their retail lending falls with under supervisory examination protocols of any of the financial regulators or the CFPB really is the pinpoint question. You have asked the pinpoint question.

Mr. SCOTT. Thank you.

Mr. Sanz, did you—

Mr. SANZ. Yes. Thank you, Congressman Scott. I would tell you that a critical difference between consumer and commercial lending is that commercial loans power the economy by enabling growth, hiring jobs, creating jobs, excuse me, buying inventory, expansion, et cetera. So the use cases for the capital is very different from between the commercial and the consumer markets.

Also I would indicate that the distinction in the regulation between commercial and consumer lending has been very sharp throughout the decades. You can see that in the Truth in Lending Act in 1968. And one of the many reasons underpinning that is that when you are talking about small business owners you are talking about sophisticated users of credit.

So just to give you a brief example of the kind of customers that we have at CAN Capital, we are not talking about consumer hobbyists, Congressman. We are talking about business owners who have been in business 13 to 14 years, who are doing an average revenue of $1 million to $2 million a year.

They have brick and mortar locations. They are managing their insurance, their taxes, their payroll, their licenses. These are absolutely sophisticated users of capital.

Mr. SCOTT. Thank you.

Chairman NEUGEBAUER. I thank the gentleman. I have been informed now that what was a five-vote series is going to be an 11-vote series. The good news some of those will be 2-minute votes, so I ask our witnesses to take a little break here.

And this hearing stands in recess subject to the call of the chair.

[recess]

Chairman NEUGEBAUER. The committee will come to order. We will now resume questioning, and I yield to the gentleman from Missouri, Mr. Luetkemeyer, chairman of our Housing Subcommittee, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Thank you all for being here today. I was interested in the last individual's, Mr. Scott's questioning with regards to small business. I guess my question is I think Mr. Adarkar, you also do individuals, do you not?

Mr. ADARKAR. Yes. We only do consumer loans. We do not do small business loans.

Mr. LUETKEMEYER. You do not do small business loans.

Mr. ADARKAR. That is right.

Mr. LUETKEMEYER. Mr. Sanz, you do small business loans and not consumer loans. Is that correct?

Mr. SANZ. Correct. We do only small business loans.

Mr. LUETKEMEYER. So but you both do online lending, right? Okay. You both do lending online.

Mr. SANZ. Correct.

Mr. ADARKAR. Correct.

Mr. LUETKEMEYER. Okay.

Mr. Nichols, one of the things that you talked about a while ago, and it is interesting because I was somebody back in 2012 or the 112th Congress, 113th Congresses, both filed a bill to have a non-bank Federal charter for online lending. And lo and behold I got criticized excessively both those terms and now here we are looking at doing this.

So I guess I was ahead of my time. It is not necessarily where I am at most of the time, but anyway I was on this issue perhaps.

You indicated that the ABA would be supportive of non-bank charters. Is that right?

Mr. NICHOLS. If designed properly and thoughtfully, yes, sir.

Mr. LUETKEMEYER. Do you see an opportunity for banks to get into this online lending?

Mr. NICHOLS. Many banks are already in online lending, yes.

Mr. LUETKEMEYER. It would seem to me to be an opportunity to expand into a different area, to deliver a different kind of service, offer a different product. I know that you said you are partnering with other people, but I would think that even the banks themselves would maybe try to look at doing this themselves as well.

Mr. NICHOLS. Yes, absolutely.

Mr. LUETKEMEYER. Okay. I assume that the banks have to comply with all different sorts of regulations. It would make sense that the FinTech companies would be doing the same things, would they not?

Mr. NICHOLS. In the context, Congressman, of this idea, the concept of a FinTech charter, there are kind of some general principles as we are approaching that and as we are meeting with the regulators, the OCC and others.

I think you have a charter because it is designed to serve the public good in some way, shape or form. So I think if there are level protections, level safeguards, in exchange for pre-emption which is presumably one of the reasons why there is a desire to be in a charter of that nature.

Mr. LUETKEMEYER. Do you think that online lending would help you with your CRA rating?

Mr. NICHOLS. Would it help with the rating?

Mr. LUETKEMEYER. Yes, with CRA?

Mr. NICHOLS. I would answer it this way. I think the idea of if you are lending in a community I think the idea of CRA being applicable probably makes sense to banks and non-banks.

Mr. LUETKEMEYER. If online lenders have to comply with all the regs that banks comply with they need to comply with CRA, too? Mr. Sanz?

Mr. SANZ. Yes, Congressman. I think that there is a good deal of thought that would have to go in to structure that. I am not a CRA expert, but to the extent that we are regulated in the same way, which I would argue largely we are today because of bank relationships.

Mr. LUETKEMEYER. Mr. Adarkar?

Mr. ADARKAR. Yes. I think it would depend on the sort of principle rationale that was underlying the bank charter and the sort of rationale for the supervision. But certainly, the goals of the CRA to the extent the CRA is intended to promote expanded access to credit is something that the space is certainly supportive of and believe that we are already being supportive of today.

Mr. LUETKEMEYER. Mr. Cordray is quoted as saying that, "small business lending is going to be one of his policy priorities in the next 2 years." And he really thinks the lines between commercial and consumer lending are blurry.

Obviously he needs a different set of glasses. Mr. Nichols, can you—or, yes, give me a difference between commercial and consumer lending that Mr. Cordray would understand here?

Mr. NICHOLS. I actually think there are some pretty significant differences there, Congressman. And I don't share the view of Mr. Cordray in this area.

Mr. SANZ. If I could add, Congressman?

Mr. LUETKEMEYER. Yes. You deal with one section of it.

Mr. SANZ. Definitely. I would highlight a number of differences. I think in the consumer market you typically see much smaller balance transactions. I think Mr. Adarkar was indicating that their average transaction is about $13,000.

Mr. LUETKEMEYER. What would the CFPB—need to protect the consumer from in your situations that you deal with business loans?

Mr. SANZ. I couldn't tell you net of the regulations to which we are subject today. Certainly, the CFPB has some plans for working on the 1071 information gathering regs, but today we are subject to a significant amount of regulation that I would argue provides sufficient protections for small business owners.

Mr. LUETKEMEYER. It looks like he is trying to get in some place where he is really not necessarily needed to go and probably for sure not welcome. But I thank you for that.

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

Chairman NEUGEBAUER. I thank the gentleman.

Now the gentleman from Washington, Mr. Heck, is recognized for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman, and indeed thank you so very much for holding a hearing on this topic, which I find interesting and timely and important. I am genuinely appreciative.

Mr. Nichols, I want to begin by using this opportunity to remind everyone present. I was inspired by your very evocative use of term sandboxing greenhouse. And I want to remind everybody that Mr. Posey and I had been working for quite some time on a no action letter legislation to expand upon what CFPB currently has issued for themselves.

And in fact we have worked with Jeff Sharp from your office considerably. He has done a great job I think on behalf of your membership. I have continued to believe that expanding upon what they, CFPB initially proposed would be a good and important step forward in this area and I want to acknowledge that.

And then I would like to ask you to characterize the degree to which you see FinTech as a material competitive threat, if at all?

Mr. NICHOLS. I don't see it as a threat. I would see it as a threat if the supervisory framework, Congressman, evolved in such a say that they would have some of the benefits and not some of the responsibilities and obligations.

For example, in the context of the Congressman's question about the charter. If you are going to have some of the benefits of a charter you should have the duties and the responsibilities I think of being in a charter.

So if public policy were to evolve in an unfortunate way I think there could be a challenge there directly answering your question.

That said, I do see more. If the public policy environment, Congressman, evolves the right way I see a lot of opportunity. I really do.

Mr. HECK. I really appreciate that you said that because I actually see, and I am not sure if I did before 6 or 8 years ago, more opportunity for collaboration and partnership here.

I am frankly a whole lot more concerned about things like the bit coin and getting outside the payment rails altogether. You are banking still the backbone of transaction in this economy.

Ms. Levi, first of all, thanks for standing up on behalf of people who on occasion need help to be dealt with fairly and equitably. I also appreciated that you acknowledged in your testimony that small business lending was down pretty significantly last year.

And I am wondering if you would briefly characterize because I would like a couple of the other people to answer as well why you think that is and what it is you think we should do about it? Because I see that, again, this whole conversation is about access to capital on behalf the people who serve as parts of the engine of this economy. And you acknowledge there is an issue here, so why do you think that is going on? And what should we do about it?

Ms. LEVI. I think that banks have a responsibility. A lot of the small business lending that has declined is because banks are not providing it. And that CRA has a role there to play.

Some of it is on the demand side as well. There is no less demand for small business loans in some regard. There is also a need for about 70 percent of small businesses want loans under $250,000.

Banks are not really interested in being in that line of business per se. They may not deem it profitable. That is also an issue. There are a number of issues.

There is a role for innovation, for financial products for small businesses, but the important thing for us is to ensure that these products come with the full panoply of consumer protection, fair lending examination and that, for example, a number of the panelists said that CRA should apply but it is how it applies. Is the retail lending also examined?

Mr. HECK. Thank you very much.

I want to give Mr. Nichols just 15 seconds to—

Mr. NICHOLS. There are so many interesting statistics here, Congressman. Just today the NFIB Small Business Optimism Index came out saying that 5 percent of small business owners reported that their borrowing needs were not met—5 percent.

And that only 2 percent of small business owners in the survey sample reported that financing was their top business problem, so there are a lot of really interesting statistics.

Mr. HECK. So do you—just to clarify. You think the perception that there isn't capital available for small business may be exaggerated beyond what actually exists? Is it fair to surmise that from what you just said?

Mr. NICHOLS. No. I would say it slightly differently. It is having traveled extensively across the country it is different regionally based on business models. So I can't answer it in a static way.

Mr. HECK. Yes, yes, I got it. Thank you.

Thank you, Mr. Chairman. I appreciate your indulgence.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Kentucky, Mr. Barr, is recognized for 5 minutes.

Mr. BARR. Thanks, Mr. Chairman, and thanks to our witnesses. This FinTech revolution is really quite exciting in many respects from the standpoint of innovation and obviously filling a gap or some demand within the financial marketplace.

But as we look and as this marketplace evolves, I think it is important that we strike the right balance. On the one hand making sure that the existing regulatory regime or the gaps in regulation perhaps as some may argue, do not prevent a level playing field on the one hand.

On the other hand, I think it is very important that Congress and regulators not overreact to stifle innovation. So I kind of want to explore that tension a little bit with Mr. Sanz, Mr. Adarkar and then Mr. Nichols as well.

So some FinTech companies are actually asking for more regulation in the form of a Federal charter or a Federal license. Mr. Sanz, I take it you are not very enthusiastic about that concept?

Mr. SANZ. I wouldn't say that I am not enthusiastic. I would say that there are a tremendous number of details that would have to be explored and vetted thoroughly to understand exactly what the tradeoffs are for a company like mine that is strictly a small business balance sheet model.

And so commercial finance companies can certainly operate in the face of the state patchwork. There are certain downsides to that. But whether or not a limited charter would be the answer I think the devil is in the details.

Mr. BARR. Mr. Adarkar?

Mr. ADARKAR. So sort of echoing Mr. Sanz's comments. I guess what I would emphasize is that I do feel that the status quo has allowed a reasonable balance to develop in the sense that the existing regulatory framework I do feel like has created a reasonable balance between consumer protection on the one hand and allowing these innovative companies to bring their innovations to market and to grow and to prosper at the same time.

And so I would be cautious about a new structure for that reason just without knowing more about where the tradeoffs would lie.

Mr. SANZ. And if I can please add, Congressman? I think it is also really important to note that many of us on the panel here today do work with bank partners and that we have established relationships with them through which we have the oversight of the bank itself as well as a Federal regulator. And that model works.

There have been some recent uncertainties created in that part of the market as a result of Madden v. Midland and other things, very excited to see Congressman McHenry's bill of last night that would address that.

Mr. BARR. I think competition and choice and providing consumers with choices and alternatives is I think a hallmark of consumer protection.

But I am curious to know and maybe this is a question for Mr. Nichols, what is it that is creating demand for non-bank lending that has fostered an environment in which FinTech companies have grown and filled in the gap?

Is it perhaps that there are regulatory pressures on community banks, credit unions, other bank lenders that make it unprofitable for institutions to provide consumer credit, small dollar loans or the products that the FinTech, the online lending industry has provided?

Or is the risk profile of an unsecured loan in the $10,000 to $15,000 range simply not in the business model of a bank, and that is to Mr. Nichols.

Mr. NICHOLS. Clearly, there are regulatory headwinds in the post Dodd-Frank landscape that banks of varying sizes have been dealing with. There is no question there. I would also observe that a number of the loans, and I think she cited this earlier in her testimony, a number of the loans are refinancing unsecured debt and other things.

And to your earlier question I just wanted to jump in there, if I may? In the context of a FinTech charter, if you are going to get the benefits of a charter, the concept of this nature, I should say, there are duties and responsibilities that would come with that, presumably with pre-emption.

And then the big question and what I think the oversight—of what I think the OCC is thinking about hard here is, again, what does the oversight model look like? That is I think the big question. That is what I think Mr. Curry and his colleagues are dealing with.

But to your question, there are a lot of headwinds facing banks, particularly community banks and the regulatory supervisory framework is certainly among those.

Mr. BARR. I would say that as we look at maybe if there is a need to level the playing field I think we instead of having government pick winners and losers I think we need to look at de-regulating some of the areas where we are talking about the Financial Choice Act.

These community banks are unable to actually compete. But in the meantime we don't want to stifle innovation where the FinTech industry is really providing access to capital where because of perhaps regulation the traditional banking model is not able to provide that, that credit for consumers, businesses and entrepreneurs.

Thank you. I yield back.

Chairman NEUGEBAUER. I now yield to the gentleman from Pennsylvania, Mr. Rothfus, for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Mr. Sanz, in your testimony you note that the online marketplace lending industry is varied and rapidly evolving and that lending models vary based on the nature of the borrower and the mechanisms used to fund the loans.

I would also add that many online marketplace lenders offer different types of financing to small businesses for more traditional loans to merchant cash advances. With this in mind, do you believe that any single disclosure requirement can sufficiently convey useful information in such an unstandardized industry?

Mr. SANZ. Thank you, Congressman. I would tell you that in our experience at CAN Capital we have found that the simple price ratio disclosure that discloses total cost alongside the basic economics of the transaction, the amount of money being provided, the amount of money that is either the receivables that are being purchased or the repayment amount associated with the loan, provides ample information to the small business owner to understand completely the cost of the capital associated with the product that they ultimately select.

What I would tell you, though, is that very much support moving to additional disclosures that not only would highlight the total cost of capital but that would also reflect the APR of these loans to absolutely create a set of uniform disclosures across all of these diverse products in this space, not only merchant cash advance but loans of various sorts, some of which use merchant cash advance-like payment features, namely where the payment is a fixed percentage of an electronic transaction stream or what have you.

That will truly empower small business owners not only to understand the price of the product that they are looking at, which I think we enable today, but also to have an ability to do an apples-to-apples comparison of the different products in the space.

Mr. ROTHFUS. Should there be a tailoring of disclosure requirements based on the unique attributes of the financial products that will be offered through FinTech?

Mr. SANZ. I think there will be the need for some specific disclosures around particular products so that customers are completely clear on how APR disclosures, for example, are made.

So for example with a merchant cash advance product, which is a purchase of future receivable at a discount, no maturity date, no interest component, no obligation to pay if the business fails, you will have to assume certain things in order to provide an APR disclosure.

You will have to assume the period of time over which the purchased receivables are delivered. You will have to assume basically a perfect performance against future expectations of revenue.

And you will also have to further assume that it is a loan product to begin with, which a merchant cash advance is not. That being said I do believe firmly that an APR disclosure will enable small business customer to be able to compare these different products even though some of them are not loans and don't have loan-like features.

Mr. ROTHFUS. Mr. Patel, would the failure of a marketplace lender represent a threat to financial stability?

Mr. PATEL. Thank you for your question, Congressman. The answer is it depends on a number of factors. One factor is the size of the market and as I laid out in my written testimony and in my introductory remarks, to this point the size of online marketplace lending is a mere fraction of the total credit market in the United States.

It also hinges on the originate to distribute model that is used in marketplace lending but at the moment given the nascent stage of the industry and its size, I would say that we are a little bit from that conversation being ripe. Feel free to ask a follow up if you would like.

Mr. ROTHFUS. I wanted to get feedback on the extent of regulation that is out there right now because there are critics of the industry who argue that it is an unregulated industry and that this supposed lack of regulation opens up participants to significant risks.

Specifically Mr. Adarkar, is the online marketplace lending unregulated?

Mr. ADARKAR. No, I don't feel that is the case, Congressman. As I indicated earlier, the loans themselves and the protections offered to customers of the consumer loans from marketplace lenders are subject to the exact same framework of protections as any traditional consumer lending program would be.

As Mr. Nichols pointed out, the difference is more in terms of oversight at the entity level as opposed to regulation of the loan products themselves.

Mr. ROTHFUS. Okay.

I thank the chairman and I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

Now the gentleman from New York, Mr. Meeks, is recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. Mr. Chairman, a few days ago—it seemed like it was just a few days ago, maybe it was about a week ago—I had the privilege to welcome OCC Comptroller Curry to my district in Queens, New York. And we went over and toured and visited some small banks in downtown Jamaica.

We made some stops at bank branches that had closed, highlighting the challenges that banks are facing today in serving underserved communities and operating in the financial industry that is increasingly or increasing dependent on online platforms.

One of our witnesses actually, Ms. Levi of NCRC joined us on that tour with the controller and took part in the ensuing discussions. And I just first want to welcome you as a member of this panel.

Mr. Chairman, for several months now, I have been calling for us to rethink, and I do think we need to rethink, on how banking in the Community Reinvestment Act, CRA, should be regulated because much has changed over the last 40 years since this law was initially enacted.

For example, we know that banks have closed nearly 5,000 branches since the financial crisis and that a great amount of financial services are now occurring through online platforms. FinTech offers both great opportunities to reach millions of Americans and small businesses that are currently underserved. And there are some great opportunities there also.

But also it raises questions and concerns in terms of equal access and consumer protections. So I think that this is a timely hearing and very important for us to have this discussion because we want to make sure that access is even and we don't have greater disparities that begin to appear.

So I guess my first question is for Ms. Levi, who says FinTech companies are not covered under the CRA. How can we be assured that the needs of low to moderate income individuals and communities are not left behind?

Ms. LEVI. And we can't without that kind of coverage. CRA is an affirmative obligation. It requires financial institutions to reach out and serve, provide services, loan products, to low and moderate income communities, underserved communities and borrowers.

And banks have that affirmative obligations, but there are a number of players in the financial marketplace who do not. And without that affirmative obligation you do see gaps in the types of products serving that segment of the market, low and moderate income borrowers.

Mr. MEEKS. We have to continue to press a little bit because I think that when we look at the wave of the future, technology is just going to be more and more and we have to make sure that we are not leaving folks behind.

In fact, let me see, Mr. Nichols, let me ask a question. Online marketplace lending is expanding access to credit into some segments by providing loans to certain borrowers who might not otherwise have received it.

And I am constantly—I met with some folks today hearing that partnerships between banks and FinTech firms may offer the best model. You have some banks and FinTech firms and they get together.

Can you please help us to understand how such partnership between online marketplace lenders and traditional lenders can help in leveraging technology to expand access to capital and into underserved markets?

Mr. NICHOLS. There is kind of the best of both worlds here. You have the innovation and the technology solution that a lot of these new FinTech companies are bringing to the market, which is fantastic.

And then you have what banks, particularly community banks have, which is the trust and the customer relationship. And it is that pairing, Congressman, that I think is so powerful and that I think what will help allow us to serve customers, clients and communities better.

I went on and on in the written testimony, but I think it is that pairing that is trying to bring—

Mr. MEEKS. Are there any risks, or what risks does the bank fear most or is most concerned about when you don't have the FinTech firms or FinTech firms are operating outside of those kind of partnerships?

Mr. NICHOLS. We talked a little bit about that and the way I view that is that the potential for risk is that you have an unlevel supervisory arrangement or a supervisory set of arrangements where you have banks subject to a set of duties and responsibilities that are perhaps different than some of the FinTech market entrants.

But what the biggest delta, sir, in the area of oversight. And that is what I think the regulators are going to grapple with. So Mr. Adarkar has said a number of times eloquently and correctly that they are subject to the same laws.

However, banks in the United States have—there is an oversight relationship with the regulators that provides remarkable visibility into what banks are doing in a whole host of areas, CRA and dozens and dozens of other areas.

That is, I think, the future question that regulators need to grapple with properly and thoughtfully.

Mr. MEEKS. Thank you. I am out of time.

Chairman NEUGEBAUER. I now yield to the gentleman from Texas, Mr. Williams, for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman. And thanks to all the witnesses for your testimony today.

I am a small business owner, have been for 44 years. I am from Texas and I am a car dealer. And I can tell you since January of 2008 Main Street has never hurt as much as it hurts today.

I wanted to being this afternoon by going back to a couple of comments made by Mr. Sanz in his written testimony that I found to be of particular value.

First of all, access to capital is the lifeblood of small businesses and a major factor of their success and failure.

Second, business owners want to focus on running their businesses not searching for funds. And finally, and maybe most importantly, all small businesses utilize funds to generate a return on investment.

Now, I have said this once, I have said it a thousand times, I don't know, frankly, how a new business starts or secures capital in this current regulatory environment. I just can't see how it can happen.

But new and innovative technologies are expanding lending platforms. In our full committee hearing this morning we heard from witnesses that confirmed to us that small business lending is down and community banks are consolidating. The very last thing we need is additional regulations that stifles innovation.

So particularly concerned when I saw that the Treasury Department suggested we should be regulating small business loans of under $100,000 in a similar manner as consumer loans. Now, from past hearing we have heard how well that has worked now for the consumer loan industry, haven't we?

So Mr. Sanz, the question to you. You noted that implementing this recommendation would impact 90 percent of small business loans. Can you go into greater detail on that topic?

Mr. SANZ. Yes, absolutely, and thank you for those comments, Congressman. We at CAN capital and within the industry that serves small business are greatly concerned at those comments from certain public officials that loans of $100,000 and less would be regulated in the same way as consumer loans.

Especially given, to your comment, sir, that we are talking about 90 percent of all small business loans in our economy. These are the use cases that small businesses have for smaller balance loans, for shorter term use cases.

And I think it is very important to note that the use of these small business products in the economy is what is truly driving the economy.

Oftentimes the consumer products that we are talking about are for debt consolidation, for consumers with higher FICO scores that are simply adding no net new capital into the economy. But with the small business products we are talking about credit that is going to create new jobs, that is used for expansion, to purchase inventory, and to manage cash flows.

And one important metric that we follow at my company is the growth of our customers year-over-year. We are very concerned to make sure that we are helping small businesses grow.

In some years we have seen same store sales between the first time that we underwrite a customer to the last time equal 4 percent growth. Sometimes it has been 9 percent growth.

So I think that that is some small indication of what firms like CAN Capital are enabling in the economy.

We are a small part of the economy. It is nascent, but it is growing. But I think it is serving a critical need for capital for these very important use cases that power the economy.

Mr. WILLIAMS. Thank you.

Mr. Patel, a question for you, are there competitive advantages or disadvantages with regards to regulatory structure for marketplace lenders as compared to banks?

Mr. PATEL. So in the current moment, as other panelists have alluded to, marketplace lenders are subject to a suite of laws and regulations that I have made reference to in my written testimony, either directly or indirectly. And I will elaborate on this for just a moment.

Those that partner with originating banks are subject to regulations both from a contractual perspective with our bank partners if our bank partners are engaging in proper due diligence on the front end. But also via potentially the Bank Service Company Act as well as an equivalent provision in Title X of the Dodd-Frank Act.

For those firms, marketplace lending firms that do not use an originating bank partner, they can be subject to many of the Federal laws that I made reference to in my written testimony, but are also subject to state licensing requirements and oversight from state authorities in which they are licensed to do business.

So the marketplace lenders are in my view subject to a wide suite of existing laws and regulations, both on the consumer protection side, the Bank Secrecy Act side, as well as securities laws.

Mr. WILLIAMS. Okay. Real quick, Mr. Sanz, can you explain how business borrowers and business borrowers are different?

Mr. SANZ. Absolutely. Thank you, Congressman. One of the many things that you see first of all is a level of sophistication on the part of the small business owner.

As I indicated before, our small business customers typically have been in business 13, 14 years on average. They do $1 million to $2 million of revenue a year. They have brick and mortar locations. They are managing their taxes, insurance, payroll, et cetera.

These are absolutely sophisticated users of capital and, again, the use case for the capital is very different than a consumer product in the economy.

Commercial credit is driving the economy by creating jobs and enabling growth and expansion, whereas oftentimes consumer products are introducing lately no net new capital into the economy, so extremely different use cases, very different product features and uses.

Mr. WILLIAMS. Thank you for your testimony.

I yield back.

Chairman NEUGEBAUER. The Chair new recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you. Mr. Chairman, we have never had an easier time for blue chip borrowers to borrow money. They are getting it at rates, there are some governments that are borrowing money at negative interest rates.

But I think all the companies that will start in garages this century will be more important to us at the end of the century than the Fortune 100 companies today. If I could buy stock in all the garages I would sell the stock in the whole Dow.

So we would all dream of a world in which every entrepreneur can borrow all the capital they need at prime. That world can't exist because 1 out of 20 of those entrepreneurs is going to go bankrupt.

And so we need to have a sector of the economy that can lend at prime plus eight. And—excuse me, speaking of technology.

Now, we have the FDIC. Those subject to the FDIC, the depository institutions who promise this guarantee are going to face substantially more regulation than others. So the question is who is going to make these prime plus eight loans? Is it going to be the depository institutions?

I have had the regulators here and I begged them and implored them to allow banks to make prime plus eight loans with some small portion of their capital. And they smile and nod and then they don't do anything.

So I will ask Mr. Nichols, do your members want to make prime plus eight loans that—and will the regulators ever allow you to do so?

Mr. NICHOLS. The members that I represent are—

Mr. SHERMAN. And when I say a prime plus eight loan, I mean a loan where that is the fair return given the risk the lender is taking.

Mr. NICHOLS. I understand, and obviously I can't speak for all the members. They are not a monolithic group, but Congressman, as a general observation, allowing market rates to be set I think is a general—in our nation it is one of the things that makes our country great.

Mr. SHERMAN. Do any of your members have a major part of their business that says we are lending money to companies that have a 1 in 20 chance of going bankrupt, but we are going to make it up with higher interest rates?

Do you know of a major or do you know of a bank that has a department that does that?

Mr. NICHOLS. Off the top of my head, Congressman, no.

Mr. SHERMAN. Okay. And you know the industry pretty well. So there has to be somebody out there loaning money to the companies that have a 1 in 20 chance of being bankrupt, going bankrupt, because those are the only companies that have a 1 in 200 chance of being the next Amazon. And there is nobody in banking doing that and I don't know whether that is your business model or your regulators, probably both.

So I will ask Mr. Sanz, do your members make loans at prime plus eight where that—and do you make loans to companies that have a 1 in 20 chance of going bankrupt?

Mr. SANZ. Yes and yes, Congressman. The cost of capital to which we provide access is risk-based. We got our start in 1998 by designing models that would provide access to capital for small businesses that have less than perfect FICO scores.

Mr. SHERMAN. Yes.

Mr. SANZ. And we were able to build models based largely on firmographic data that helped us assess the health of the business, so—

Mr. SHERMAN. And it is not just the FICO score. If the pizza tastes like cardboard, the business is going bankrupt.

Mr. SANZ. Absolutely, Congressman. I would tell you that what is important to us some of the elements that are very important to us as we look at the financial strength of a small business, we are looking to underwrite is their revenue, their revenue trends, their time in business. Firmographic data—

Mr. SHERMAN. I would also point out that we also have the venture capitalists, the initial public offerings, a host of other means and Reg. D and we have talked Jobs Act, et cetera, a host of other ways of providing capital that expects a much higher rate of return than prime or prime plus two and that is willing to take substantially greater risks.

I just hope that when the American Bankers Association comes back here in a few years they say, Sherman, you prodded those regulators. You prodded us and five and 10 percent of our members are spending—they are having 10 percent of their portfolios being lent out to businesses that have a 1 in 20 chance of going bankrupt and we are charging prime plus eight. But you are not there and somebody needs to be.

Mr. NICHOLS. One thing I would say, Congressman, what makes the community banking model in this country so special is that with great respect to the current evolution of FinTech, a keystroke or an algorithm is never going to replace one person looking at another in the eye and saying let us talk about your business plan. Let us talk about your assumptions. Let us talk about your modeling.

Mr. SHERMAN. Yes. And when your regulators—

Mr. NICHOLS. That personal touch—

Mr. SHERMAN. —let you do that, you should do that.

Mr. NICHOLS. I understand. I am saying but that personal touch, particularly on the part of community banks is not likely to be replaced any time soon in my opinion.

Mr. SHERMAN. I will just say from the standpoint of the business, we like to tell you that we love our bankers because of their personality and the confidence that they give and the personal relationship. We really just want the money and while it would be good to get a loan based on that personal relationship, if we don't get it we will deal with Mr. Sanz's computer and we will be just fine.

I will yield back.

Chairman NEUGEBAUER. I thank the gentleman.

Now the gentleman from New Hampshire, Mr. Guinta, is recognized for 5 minutes.

Mr. GUINTA. Thank you very much, Mr. Chairman. I appreciate you being here today and dealing with our vote schedule in the middle of our hearing.

I am very interested in learning a lot more about the online marketplace. I am interested in seeing the new innovative and technology platforms that grow and give more opportunities and options to individuals.

I represent New Hampshire. Small business is our backbone. Ninety percent of our economy is driven by small business. We have almost 300,000 people employed by small business owners.

And while I think our community banks in New Hampshire do a great job of providing access to capital to individuals, there are those who still have challenges with access to capital and particularly in part, from what I hear and what I am told by my community bankers, are the regulatory challenges of Dodd-Frank.

And so it is a concern to me when I then talk to a customer of a bank who says because of the restrictions I cannot grow, expand or start my business. So this space is interesting to me because I think it provides more alternatives and options.

But first I would like to start with Mr. Sanz. And I know that you have covered this a little bit before, but I am hopeful that my New Hampshire constituents will hear it and appreciate it.

If you could just quickly talk about the online small business marketplace and how it actually would provide more access to capital to those individuals that may not otherwise benefit from the existing bank that they have?

Mr. SANZ. Absolutely. Thank you for the question, Congressman. I would tell you that the way in which firms like CAN Capital have expanded access to capital for underserved small businesses, is through a focus on technology and data-driven algorithms.

I think with all respect to bankers and the banking community, that we value. We have a banking partner. It has been difficult for banks to provide access to loans of 250 and less, maybe even a million and less to small business because of very high costs of acquisitions, search costs, underwriting costs of various sorts.

Companies like CAN Capital we embrace the technology-enabled model that significantly reduces those costs by automating many features of the underwriting process, by building data-driven models that take certain inputs and provide some significant insight into the current and future financial health of the small business and their eligibility for loans and their ability to pay.

So by relying on technology, building data-driven models and, candidly, over 18 years, amassing data about those transactions, those daily interactions with customers, developing very deep insights into hundreds of different industries that enable us to identify like customers almost instantaneously and predict their future financial health and underwrite them on that basis.

Mr. GUINTA. So given the fact that we have had 800,000 fewer small businesses started during the last several years nationally, which is where I think we can point to a problem with economic growth and a problem with wage inequality or the term that I hear, wage inequality.

There is less job opportunity and availability. When you have 800,000 small businesses that have not been created that should have been. So that is why to me I think that there is an opportunity here for greater access.

One thing I wanted to ask Mr. Adarkar, I am also concerned about either the unbanked or the under banked and how this can provide greater access to that space and that community?

Mr. ADARKAR. Thank you, Congressman. We believe our platform expands access to credit by reducing the cost of credit.

Mr. GUINTA. Yes.

Mr. ADARKAR. Now, as a result of the combination of innovative technology, as well as operational efficiencies in the sort of focused expertise we bring to our particular product, we believe we are able to price our borrowers at a rate that more accurately reflects the cost of their credit. And in that way, we believe that we are able to expand access.

Mr. GUINTA. Okay. I appreciate it. Thank you all for being here today. Thank you, Mr. Chairman, and I yield back.

Chairman NEUGEBAUER. The Chair now recognizes Mr. Pittenger for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank each of you all for your endurance and patience today. I started my first business in the 1980s and I had to borrow $150,000 from a banker, and he knew me and I knew him. And I was very fortunate to get the loan.

He was paid back. We had a good mousetrap. We had a good idea. And this some years later I was asked to join a community bank board, and this was during the 1990s. And from the time we chartered the bank until the time we sold the bank to a mid-sized banking institution.

And, we knew who to loan money to. I was kind of the P.R. guy and we had a lot of golf tournaments and cocktail parties and a good relationship. And they knew us and we really knew them and when in our loan meetings there was a box we checked on character. And we knew those folks.

Now, I don't see a box on character today to check. And that entrepreneur has been the lifeblood of our economy. It is what has made America so unique, that people come to America for opportunity and to take their idea and their dream, their vision, their work ethic, the risk and to build something.

And now I believe our entire economy is really threatened for the long term because an entrepreneur doesn't have a place to go. And I think that is the greatest threat, challenge we have in the future.

So as one who believes in markets and open markets and free markets and competitive markets, I am grateful for choices that we have in the marketplace that allow someone to identify their cost of capital and prime plus eight or whatever that is and they fit that in their model. And if it works it works. And they go off and run.

So I applaud the work that is being done and the effort and the tenacity and the genius of folks who get out there to create something that is really needed in our economy today.

With that in mind, Mr. Sanz, I would just like to get some understanding. There is a lot of conversation that your business is not regulated. Yet I have read in your testimony in the appendix a broad matrix of applicable laws and regulations that you have to respond to and comply with.

Could you outline some of these existing laws and that you have to comply with and then give us a framework of what you have to be accountable to?

Mr. SANZ. Absolutely. Thank you for the question, Congressman. So today in our business we are subject to multiple layers of Federal and State regulation. We act both as a direct lender.

We also have a relationship with a partner bank and as a result we are subject to rules and regulations, for example, regarding fair lending at the Federal level, ECOA and Reg. B on the commercial credit side. We are subject to both Federal and state laws regarding unfair and deceptive acts and practices, the various other laws that we set forth in the appendix.

And importantly we are subject to an additional layer of regulation through the relationship that we have with our bank partner. That results in not only being subject to the oversight of the bank's own Federal regulators, the FDIC, but also to the bank itself, which entails requiring a robust compliance management system, regular third-party audits by reputable audit firms, as well as approximately quarterly audits by the bank itself for compliance with the credit policies, all compliance policies and procedures under AML, BSA, FCRA, et cetera.

Mr. PITTENGER. Thank you. Give me a better understanding of how business borrowers and consumer borrowers are different?

Mr. SANZ. I am sorry, sir. I didn't hear you.

Mr. PITTENGER. Business borrowers and consumer borrowers—

Mr. SANZ. Thank you, sir.

Mr. PITTENGER. —the distinction between the two?

Mr. SANZ. Thank you, sir, I appreciate it. What we see in our business absolutely is a number of things. I have said before, and I hope you don't mind my repeating, one major difference is the use case for the capital.

What we see in the consumer industry is consolidation of debt at somewhat lower prices. What we see on the commercial side of the ledger is that capital is being used to drive the economy, to the creation of new jobs, expansion, remodeling, managing cash flow.

We also see in our customer base a very high level of sophistication. Business owners, like many Members of Congress who have been here today, namely people who have been running businesses for decades, who are managing revenue in the millions of dollars, who are accessing capital for 50,000, 100,000, 150,000 as you indicated, Congressman, to drive their businesses forward, so very different uses and significantly different profiles in terms of the user.

Mr. PITTENGER. Thank you.

I would yield back. My time is up.

Chairman NEUGEBAUER. I thank the gentleman.

I would ask unanimous consent that one Democrat and one Republican have one mini-round here.

And with that I will yield 5 minutes to the gentleman from Georgia for an additional question.

Mr. SCOTT. Okay. Thank you. Thank you, Mr. Chairman.

I want to make sure I get some clarity on where everybody stands regarding this May 2016 letter that the Treasury Department has put forward. And I started on that before the last session.

And the paper made the conclusion that the micro business loans, any loan to a small business under $100,000 shares similar characteristics as consumer loans and should be subject to the same consumer protection.

So I think we need a clarity answer from each of you all. Do you all—who agrees with this conclusion? Now, the marketplace lenders, if I am correct, you are currently regulated under the Truth in Lending Act.

Is that correct? Anti-money laundering and the Fair Credit Reporting Act, but you are not under the same level of scrutiny as the traditional banks. Is that where we are? Am I correct there?

Mr. ADARKAR. Congressman, sorry, I think I would distinguish between marketplace lenders engaged in consumer lending versus those engaged in small business lending. And my point earlier is that we are—for marketplace lenders engaged in consumer lending the regulatory framework is the same as it is for traditional bank lending programs.

Ms. LEVI. I would like to add—

Mr. SCOTT. Okay.

Ms. LEVI. —the bottom line, whether it is $25,000, $100,000, whatever the size of the loan the bottom line is that marketplace lenders should be subject to things like the Equal Credit Opportunity Act, the Fair Credit Reporting Act. Not only subject to, but examined under.

Mr. SCOTT. Yes.

Ms. LEVI. This lending has to be supervised and examined in the same way that depositories are examined. And if they do not comply with fair lending laws and regulations, those products really should not be in the marketplace.

Mr. SCOTT. The other part I want to get at is that as we are bouncing back from the recession, perhaps the most targeted group that is struggling the most to get access to this credit are African Americans. Am I right? Does anybody disagree with that?

Ms. LEVI. It certainly is what you see in the HMDA data.

Mr. SCOTT. Yes.

Ms. LEVI. There has been a tremendous drop off on certainly where we have data you do see that.

Mr. SCOTT. Right. And so the issue becomes can we get any indication from you all as to which way we should go here in Congress to get a more even playing field to try to figure out why there is this inability, particularly with the African American community to get access, and particularly because that is a community that desperately needs this wealth building process in this community to start a new business, which many want.

Ms. LEVI. Let me—

Mr. SCOTT. To hire a new employee to get themselves lifted up.

Ms. LEVI. Let me say this. The fact that you do not have affirmative obligations like CRA for non-bank lenders—

Mr. SCOTT. Yes. Explain when you say affirmative action.

Ms. LEVI. In other words, depository institutions under CRA they have to be affirmatively reaching out—

Mr. SCOTT. Yes.

Ms. LEVI. —outreach providing products and services to low and moderate income borrowers in the community. It is an affirmative, an obligation that requires that they take a step forwards. Nonbank institutions by and large do not have those kind of affirmative obligations on them.

So if you don't have that you are going to see some gaps. And let me just say this. Also not having fair lending reviews is a problem. Let me give you an example from the bank context.

We have seen 15 instances in the last few years of large redlining settlements—

Mr. SCOTT. Yes.

Ms. LEVI. —consent orders as a result of direct supervision by CFPB, HUD and state attorney generals. You have to be reviewing the lending to ensure that it is fair and equitable to low-and moderate-income communities, minorities, rural communities, and the like.

Mr. SCOTT. Okay.

I see my time is up, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

My last question is when marketplace lending started off kind peer-to-peer, then we started having some institutional investors come in. Then we have seen the securitization.

And so I guess the first question is is some people kind of have said that the current economic situation and policy of the Fed has a whole bunch of people out there looking for a lot of yield.

This was a perfect storm where the marketplace lenders came in and were able to provide an opportunity for lenders to get—or for investors to get a higher return and for borrowers to get a lower interest rate.

Going forward how do you sustain your business model where the economic conditions, one, change and secondly interest rate environment changes? Does anybody want to pick that one up?

Mr. SANZ. Thank you, Congressman. I would tell you that with respect to CAN Capital we don't sell any of the assets that we originate. We are a balance sheet model. We retain all the risk of all of the assets that we either originate or that we buy from a bank partner. And we rely on lines of credit from lenders.

We don't have future flow arrangements. We are not originating to sell. And so I don't know that with respect to my business model that I could directly address your question because we are not a marketplace lender in that sense.

Chairman NEUGEBAUER. Okay.

Mr. Adarkar? Go ahead.

Mr. ADARKAR. Sure. Thank you, Mr. Chairman. What I would say on the investing side of our business is a significant portion of the investors on our platform, whether they are retail or institutional, are value-driven. And they are attracted by the risk-adjusted returns of our product.

So in that sense I do not believe that a change in the interest rate environment would change the value they saw in our asset relative to the risk reward tradeoff in comparable asset classes.

On the borrowers' side of the business, our most typical borrower is someone who is refinancing higher interest credit card debt. So for those folks we would expect that rates, the competing rates they were seeing in that sector were sort of moving in line with the general movement in interest rates overall.

So we do not expect that a change in the interest rate environment would hurt that side of our business either.

Mr. NICHOLS. Mr. Chairman, I would say obviously banks are looking for some interest rate normalcy. That is just an aside. But one of the advantages here of being a bank is you have the stable funding aspect and that banks will be there for you in a credit or an economic downturn, which is certainly an advantage of the U.S. banking system in the context of your question.

Chairman NEUGEBAUER. And so then what we have heard a lot of discussion today about is looking at what kind of regulatory environment do—marketplace lenders need to operate in, which what we have seen happen to our friends in the banking industry is we saw more regulation put on them that changed their business model.

So if the regulatory environment gets more aggressive in the marketplace lending what is the likely outcome of change? Will you have to change your business model and will that change your funding model as well?

Mr. Adarkar?

Mr. ADARKAR. Sure. What I would say in that respect is with all due respect to Mr. Nichols, I believe that what has driven the success in our space is not necessarily a difference in allocation of regulatory resources so much as it is our ability to develop innovative technology, our ability to create operating efficiencies and our ability to focus and develop product expertise in a very specific area with a very particular type of product to a degree that would be difficult for most traditional banks.

And so I do feel like there are certain inherent significant competitive advantages that explain the great bulk of our success that would still be present in a different regulatory environment.

Of course any new regulatory scheme we would like to see it apply in a way that was balanced and fair across the spectrum of lenders and in a way that didn't overly stifle innovation. But we don't believe that regulatory change would necessarily go at the heart of what we see to be our competitive advantage.

Chairman NEUGEBAUER. Mr. Patel, Madden V. Midland Funding, how is that ruling going to impact marketplace lenders?

Mr. PATEL. So I would say Madden has been a source of uncertainty in this industry. Frankly, the Madden case, the resolution of it is still uncertain. There are a couple of issues to be decided on remand by lower courts.

Chairman NEUGEBAUER. Can you talk a little bit more into your microphone there for me?

Mr. PATEL. Can you hear me now, sir?

Chairman NEUGEBAUER. Yes.

Mr. PATEL. Great. Sorry. Madden has been a source of uncertainty. The resolution of the case is yet uncertain. There are a couple of issues that need to be resolved by the lower courts, specifically the application of valid when made and choice of law issues.

But more to the macro point on Madden, Madden creates uncertainty as to whether or not interest rates charged on certain loans are valid and thus whether those loans comply with a series of legal requirements, including state usury laws, potentially even Federal RICO laws.

So on the whole this is one reason I would expect that certain FinTech companies are advocating on behalf of a national charter of some sort whether a bank charter or something more limited, because they want to quell some of the uncertainty created by the Madden decision, which frankly depending on your read, is distinct from court of appeals cases in other areas of the country.

Chairman NEUGEBAUER. I want to thank the—

Mr. SCOTT. I want to do that.

Chairman NEUGEBAUER. —oh, I am sorry.

Mr. SCOTT. Yes. If I could, Mr. Chairman, I would like to introduce for the record this letter of July 11th from the National Association of Federal Credit Unions (NAFCU).

Chairman NEUGEBAUER. Without objection, it is so ordered. I would like to thank our witnesses for your testimony today. And without objection, I would like to submit the statement of the Financial Services Roundtable. We had the credit union and the report from the Financial Innovation Now.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Again, I thank our witnesses for your patience, and with that, the hearing is adjourned.

[Whereupon, at 5:40 p.m., the hearing was adjourned.]

A P P E N D I X

July 12, 2016

United States House of Representatives
Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

"Examining the Opportunities and Challenges with Financial Technology ('FinTech'): The Development of Online Marketplace Lending"

July 12, 2016

Written Testimony of Sachin Adarkar, General Counsel and Chief Compliance Officer Prosper Marketplace

Chairman Neugebauer, Ranking Member Clay, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is Sachin Adarkar and I am the General Counsel and Chief Compliance Officer of Prosper Marketplace. I am honored to be here representing Prosper.

Prosper Marketplace launched in 2006 as the first U.S marketplace lending platform. Our proprietary online platform connects borrowers who are looking for unsecured loans with individuals and institutions who wish to invest in those loans. To date, more than $6 billion in loans have been funded through the Prosper platform, helping people refinance high-interest credit card debt and pay for large expenditures, such as medical bills. All loans made through the Prosper platform are originated and made by WebBank, an FDIC insured industrial bank, under a credit policy approved by WebBank's board of directors. Prosper services all of the loans originated through our platform.

Prosper is the second largest consumer marketplace lending platform in the United States. Some marketplace lending platforms, such as Prosper, offer investors the opportunity to invest in individual loans. Other marketplace lending platforms hold the loans themselves and collect interest and principal payments over the life of each loan.

Benefits to Borrowers and Investors

The Prosper platform offers borrowers access to fixed-rate consumer loans, ranging from $2,000 to $35,000, with fixed loan terms of three or five years. We facilitate a fast and transparent loan origination process that includes clear disclosure of all costs and fees, and we offer access to competitive interest rates. The minimum FICO score for eligibility on the Prosper platform is 640, and the average FICO score is 705. The most common reason for taking out loans is to refinance existing unsecured debt, such as credit card debt, at lower interest rates and on more affordable terms.

Prosper uses mostly automated processes to verify the identity of borrowers and assess borrowers' eligibility and credit risk under the Prosper-WebBank credit policy. We have developed innovative technology to make these processes efficient and effective.

For investors, the Prosper platform offers access to an attractive asset class with steady cash flows and consistent returns. The estimated weighted average return on loans originated through our platform in June 2016 is approximately 7.4%. In order to help our investors make well-informed investment decisions, we provide them with a high level of transparency. At the time an investor on our platform is considering investing in a loan or related security, we provide them with detailed, *anonymized* data regarding the borrower's credit characteristics. After an investor has purchased a loan or related security, we also provide them with detailed performance data regarding the loan. We believe this approach creates an open and fair process for all participants in our marketplace.

Compliance and Regulatory Overview

Loans originated through the Prosper platform are subject to the same comprehensive regulatory framework as loans originated through any traditional consumer lending program. All of our loans must comply with the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act and the Patriot Act, among other laws and regulations. Because WebBank, our issuing bank, is FDIC-insured, the loan program is subject to direct regulatory oversight by the FDIC as well as the Utah Department of Financial Institutions. The FDIC also has examination and enforcement authority over Prosper under the Bank Service Company Act. Additionally, Prosper is subject to the enforcement authority of the Consumer Financial Protection Bureau and the examination and supervisory authority of a number of state licensing bodies. The Prosper retail investment product offerings are subject to oversight by the Securities and Exchange Commission as well as state securities regulators.

Prosper has developed a robust compliance management program that includes strong compliance-related controls, governance, and policies and procedures for all aspects of our operations. We are proactive in raising issues of potential concern with regulators, and we are committed to continuing this open and transparent dialogue. We recently joined with other leading marketplace lending platforms to form the Marketplace Lending Association (MLA), which aims to facilitate this dialogue and encourage the responsible growth of our industry.

Conclusion

We believe marketplace lending brings significant value to both borrowers and investors, and that it will play an increasingly important part in the financial industry in the years to come. I want to thank you for this opportunity to provide an overview of our business and industry, and I welcome future opportunities to discuss these issues.

Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending

Written Testimony of

Gerron S. Levi

Director of Policy & Government Affairs

National Community Reinvestment Coalition (NCRC)

Before the Subcommittee on Financial Institutions & Consumer Credit

House Committee on Financial Services

U.S, House of Representatives

July 12, 2016

Introduction

Good afternoon, Chairman Neugebauer, Ranking Member Clay and other distinguished members of the House Subcommittee on Financial Institutions and Consumer Credit. My name is Gerron Levi, and I'm the Director of Policy and Government Affairs for the National Community Reinvestment Coalition. NCRC and its over 600 grassroots member organizations create opportunities for people to build wealth. We work with community leaders, policymakers and financial institutions to champion fairness in banking, housing and business development. I appreciate the opportunity to testify this afternoon about developments in the FinTech market, the current regulatory structure and recent policy development.

Much of my testimony today will focus on non-bank lenders who make small business loans, with occasional reference to small dollar lending and other FinTech activities; I draw significantly from NCRC's comments to the Office of the Comptroller of Currency ("OCC") on their recent request for information on innovation, and I'd like to acknowledge my colleague Josh Silver's contributions on that score.

The rapid growth of non-bank lenders – so called "Marketplace" lenders – to small businesses raises serious concerns that Congress should address. We see echoes of the early days of the subprime mortgage boom, in which rapidly growing non-bank mortgage lenders innovated in the worst possible way: by loosening credit standards, layering significant and multiple forms of risk, and causing financial harm to borrowers who could ill afford to repay the loans. If lightly regulated non-bank small business lenders – including FinTech firms – are left unchecked, our fear is the impact may be the same: millions of small businesses stuck with exploding loans they can't afford, and the American taxpayer left on the hook to clean up the mess.

For example, one of our members, PathStone Enterprise Corporation based in Rochester, New York, reports:

> "We have started to see small businesses saddled with high interest rate loans from marketplace lenders, unaware of the more problematic aspects of the loan. For example, they don't know that they have also agreed to significant prepayment penalties that make it impractical to refinance the loan. They are also unaware that the interest compounds daily and that there are daily payments pulled directly from their bank account. The flow of small business borrowers starting to come to us with problem loans is reminiscent of the early days of counseling borrowers stuck with a bad mortgage."

While the scale is currently different from non-bank mortgage lending, both the regulatory infrastructure and the incentive structure within which most FinTech firms operate may contribute to risky small business or consumer lending that is of serious concern to NCRC and its members.

Will innovation balance access to credit, convenience and needs, and borrower protection?

When evaluating these online lending platforms and their sophisticated underwriting algorithms, NCRC is certainly interested in expanding safe and sustainable credit access, but also in the process these channels raise other concerns that could undermine the sustainability of the marketplace lending model, lead to regulatory arbitrage, and mask predatory practices and fair lending violations in the marketplace.

FinTech innovation has distinct connotations depending on whether the stakeholder is a banker, regulatory agency, small business, or community organization. Financial institutions often consider innovations as concepts or processes that save money and increase profits.

From a community perspective, innovation should mean developing the means to serve underserved communities on a large scale in a responsible and sustainable manner. For example, the thirty-year mortgage was a key innovation that dramatically increased homeownership among working class and middle class families for decades. In contrast, other supposed "innovations" such as subprime lending and private label securitization wiped out a significant amount of the gains in homeownership and equity building in minority and low- and moderate-income communities.

Whatever innovation FinTech firms bring to the marketplace, Congress and the regulators should act to ensure it is responsible, and that consumers actually benefit from the innovation.

The romance and reality of FinTech: will it develop the large-scale ability to responsibly serve consumers?

There is no doubt that innovative solutions are needed to address a fundamental issue: small business lending is down, and businesses are dying on the vine for lack of credit. For example, the number of loans issued by 10 of the largest banks in the U.S. has decreased 38 percent to $44.7 billion in 2014, the Wall Street Journal reports, down from a peak of $72.5 billion in 2006.[1]

Enter financial technology firms offering enticing, easy to use platforms that deliver loans within hours and days, not weeks. With a click of a button, a consumer can get a loan. But can online platforms serve borrowers efficiently while balancing consumer protection concerns, or is lending an inherently complicated business that requires care, deliberation, and a high-touch process?

A recent Treasury Department paper examining online lending indicates that a key feature is loan approval within 48 to 72 hours.[2] The allure of the ease has helped fuel a boom in the so-called "FinTech" industry. In its white paper, the OCC estimates that FinTech companies in the United States and the United Kingdom increased to more than 4,000 and that investment in FinTech companies has surpassed $24 billion worldwide.[3] FinTech companies tout up-and coming-technology that appears particularly well suited to the Internet and digital proclivities of the millennial generation now starting to enter their prime earning years and pursuit of homeownership.

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[1] Simon, Ruth, "Big Banks Cut Back on Loans to Small Business" *Wall Street Journal*, November 26, 2015: http://www.wsj.com/articles/big-banks-cut-back-on-small-business-1448586637

[2] U.S. Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, p.5.

[3] Office of the Comptroller of Currency, *Supporting Responsible Innovation*, p. 3, March 2016.

Market analysts estimate marketplace lenders' loan origination volumes could reach $90.0 billion by 2020.[4] The current volume, however, still pales in comparison to an estimated $1 trillion addressable market, or the current small business holdings of $598 billion by banks.[5]

Ominous signs, however, counsel caution regarding the promise of FinTech to sustainably and responsibly serve small businesses.

For example, a recent survey of small businesses by several Federal Reserve Banks reveals that 20 percent of small businesses obtaining credit used online lenders and that microbusinesses used online lenders to a greater extent. However, online lenders received low satisfaction scores. Only 15 percent of small businesses using online lenders were satisfied. Small businesses complained about lack of transparency and unfavorable repayment terms. Seventy percent of those unsatisfied complained about high interest rates.[6] A recent study of marketplace loans by NCRC member the Woodstock Institute found effective interest rates (including fees) ranging from 36-367% across a variety of providers.

Additionally, the ability of FinTech firms to comply with a range of consumer lending protections, as well as operate safely and soundly, has been brought into sharp relief by the recent Lending Club scandal, in which the firm's CEO resigned following the discovery that the firm had essentially committed fraud through the misrepresentation of loans.[7] Some reports have suggested that such a significant lack of internal controls are not limited to Lending Club, but might be endemic to the industry, rendering them unable to survive a normal business cycle.[8] In fact, charge-off rates have recently risen dramatically at Lending Club, up 38% since 2013, raising the possibility of further defaults and financial woes.[9]

Additionally, the ability of FinTech firms to attract sustainable sources of capital is another area of concern. Investments are slowing down in FinTech.[10] In the wake of the Lending Club scandal, investors are increasingly concerned about the online and FinTech model and how well it can withstand recessions as well as healthier economic times. NCRC is concerned that FinTech

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[4]United States Department of Treasury, *Opportunities and Challenges in Online Marketplace Lending*, p.9, May 10, 2016:https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf

[5] Guta, Michael. "Big Banks Still Lend Small Businesses Less Than a Decade Ago." *Small Business Trends*. Small Business Trends, 06 Dec. 2015.

[6] Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, *2015 Small Business Credit Survey, Report on Employer Firms*, see https://www.frbatlanta.org/research/small-business/survey/2015/report-on-employer-firms.aspx?panel=2

[7] Rudegeair, Peter, "Lending Club CEO Fired Over Faulty Loans," *Wall Street Journal*, May 9, 2016:http://www.wsj.com/articles/lendingclub-ceo-resigns-over-sales-review-1462795070

[8] Corkery, Michael, "As Lending Club Stumbles Its Entire Industry Faces Skepticism", *New York Times*, May 9, 2016: http://www.nytimes.com/2016/05/10/business/dealbook/as-lending-club-stumbles-its-entire-industry-faces-skepticism.html?_r=2

[9] Demos, Telis and Rudegeair, Peter, "Lending Club's Newest Problem: Its Borrowers, *Wall Street Journal,* July 11, 2016: http://www.wsj.com/articles/lendingclubs-newest-problem-its-borrowers-1468265212

[10] Demos, Telis and Rudegeair, Peter, "Has Fintech Boom Peaked?", *Wall Street Journal,* January 20, 2016: http://www.wsj.com/articles/has-fintech-boom-peaked-1453458781

firms could find deposits an attractive source of capital, and begin to blur the line between different lines of business, such payment systems, lending, and deposit taking.

Borrowing significant sums of money is a complex financial transaction. For many consumers, particularly low- and moderate-income consumers, it is the most complicated transaction they will ever undertake. Executed responsibly, lending can empower consumers and enable them to build significant equity. Executed irresponsibly, lending can result in financial ruination. And given its complexity, lending often requires significant amounts of counseling and underwriting to ensure that borrowers can afford the loan and make payments. A click of a mouse and fancy algorithms are often no substitute for patient counseling and careful underwriting, particularly for those unfamiliar with lending and not possessing an established credit history.

Data and transparency concerns

In order to realize a consumer- and community-friendly definition of innovation, regulatory agencies must develop systems for monitoring performance of financial institutions. The development of data systems is one of the most important ways to effectively measure whether financial institutions are achieving innovation as defined by serving minority and working class communities at a large scale with responsible products. The Home Mortgage Disclosure Act (HMDA) data is valuable in measuring the volume and percent of loans to minorities and low- and moderate-income borrowers. But HMDA data needs to be supplemented with data on loan performance including delinquency and defaults to determine not only whether institutions are reaching the underserved but also whether their products are sustainable and safe and sound. Also, the new Dodd-Frank[11] HMDA data elements regarding loan terms and conditions will provide additional insights into the sustainability and affordability of loans.

When HMDA data is more effectively paired with data on loan performance and loan terms and conditions, regulators and the general public can compare institutions regarding the extent to which they are responsibly reaching underserved populations. These analyses would involve comparing institutions with traditional technology and those with "innovative" technology such as online lending platforms to actually determine which institutions are more effectively serving overlooked populations. It is NCRC's position that if traditional institutions reach a higher percentage of minority and modest income borrowers with safe and sound loans than institutions with newer technology, then the traditional institutions are actually more innovative from a consumer and community perspective.

Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires lending institutions to publicly disseminate data on their small business lending activities. The purpose of the section is, "to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses." This critical purpose of ensuring that lenders are held accountable for responsible lending to traditionally underserved businesses will best be fulfilled if the data reporting requirement is applied broadly throughout the financial industry to include not only banks but also non-bank financial institutions such

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

as FinTechs. The Consumer Financial Protection Bureau (CFPB) will be undertaking a rulemaking process in the near future. Interested stakeholders and members of Congress should convey to the Board the necessity of broad coverage of the financial industry, which is authorized under Section 1071 of Dodd-Frank.

Fair lending concerns

A significant market advantage of many Fintech firms, is their use of Big Data to underwrite loans. Advocates for Big Data argue that it improves credit risk profiling, and may expand the number of people "scored," expanding access to credit. But does Big Data truly represent an improvement, or is it simply skating around the guardrails in place for good reason?

Vigorous enforcement of the fair lending laws is vital since FinTech companies apply opaque algorithms to assess borrower applications. The Treasury Department, in its paper, notes concerns regarding the possibility of fair lending violations due to the use of new data and credit models using undisclosed methodology. The Treasury Department adds that unlike the traditional credit report model, consumers will not have the ability to check and verify the personal data used by FinTech companies to determine loan eligibility.[12] The agencies must collaborate in vetting the credit review and approval methods of FinTech companies to guard against discrimination and fair lending violations.

Enforcement authority may need to be shifted in order to respond effectively to technological change. For example, enforcement of the Equal Credit Opportunity Act (ECOA) is currently split among the prudential bank regulatory agencies and the CFPB. The bank agencies enforce ECOA when banks have assets of less than $10 billion while the CFPB enforces ECOA when banks have assets of $10 billion or more. The CFPB enforces ECOA in the case of non-depository mortgage companies. Splitting authority among several agencies for enforcing a fair lending law risks inconsistencies in enforcement. Since the CFPB is currently in charge of enforcing ECOA in the case of the large banks and non-depository mortgage companies, it would make the most sense if the CFPB was in charge of all ECOA enforcement including for smaller banks and any FinTech companies receiving a bank charger. At the very least, Dodd-Frank requires cooperation in fair lending enforcement among the prudential bank regulators and the CFPB. In the case of smaller banks (including any FinTech companies), Dodd-Frank mandates that the federal bank agencies grant the CFPB examiners the opportunity to participate in the exam, review exam documents, and offer input. It would seem that these procedures are especially needed when examining small banks with new FinTech-like technologies that may eventually be adopted by larger banks and mortgage companies under the jurisdiction of the CFPB.[13]

The legal and regulatory response to FinTech

[12] U.S. Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, p. 20.

[13] Congressional Research Service, The Consumer Financial Protection Bureau, A Legal Analysis, January 2014, https://www.fas.org/sgp/crs/misc/R42572.pdf

The regulatory response to FinTech companies will be critical in determining whether they are helpful and responsible financial institutions or whether they will become another in a line of predatory lenders that will ultimately become extinct after fleecing borrowers. The objective must be to apply a comprehensive set of regulations to FinTech companies and more traditional lenders so that consumers and financial institutions can both thrive in the marketplace.

The OCC has already put out feelers to the industry and dangled some regulatory favors in front of them. An American Banker article features a senior OCC regulatory official discussing a limited purpose charter for FinTech companies so that they can become nationally chartered banks and avoid the hassle of seeking licenses in multiple states.[14] But before the OCC offers a limited purpose charter to any new financial institution and confers the enormous benefits of a national charter, it must ensure that the institution is responsible (Also NCRC opposes a national charter that would allow a FinTech to operate as a non-bank; it would need to convert to a bank).

Importantly, while the OCC has asked for comments about innovation, several agencies including the OCC have also requested comment regarding reforms to the consumer compliance rating system. In its comments on the rating system, NCRC advocated for public input to examiners conducting compliance reviews and for the public release of ratings. The ratings could then be key for considering applications by non-banks including FinTech companies for bank charters. Only FinTech companies and other non-bank entities with the highest proposed rating (a proposed "1") should be allowed to acquire a national charter from the OCC.[15] In order to be eligible for a bank charter, a non-bank entity must have an outstanding record (a "1" rating) of compliance with consumer and fair lending compliance law.

The limited purpose charter as currently applied in the Community Reinvestment Act (CRA) examination context amounts to an easy-pass with no accountability for so-called limited purpose banks that make substantial amounts of retail loans. Under the current CRA regime, any FinTech "bank" designated as limited purpose would have a CRA exam that fails to scrutinize its retail lending. Would it be acceptable, for example, if a company named "Lending Club" that has issued $18 billion (and $2.7 billion last quarter) of loans to consumers and small businesses has a CRA exam that does not examine the effectiveness of its retail lending in serving low- and moderate-income borrowers?[16]

Regardless of any particular charter that might be granted to FinTech companies, CRA exams must scrutinize retail lending since FinTech companies, by their nature, are geared towards retail consumers. Limited purpose CRA exams focus on community development (CD) lending and qualified investments. While CRA exams should encourage CD lending and investment, they must also examine FinTech firms for what they purport to be, namely retail institutions. To do otherwise would violate the guidelines in the OCC's licensing manual which reiterates a need for

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[14] Lalita Clozel, American Banker, "OCC Weighs New Charter for FinTech Firms" *American Banker*, May 10, 2016.

[15] Some non-bank entities such as mortgage companies or FinTech firms that issue home loans are regulated and would receive consumer compliance ratings. For those that are not regulated and subject to a consumer compliance exam, they could not apply for a federal bank charter until state or federal law changes to require them to be regulated.

[16] See https://www.lendingclub.com/info/statistics.action.

a strong public duty requirement and emphasizes that newly chartered banks must meet, "the credit needs of its entire community, including low-and-moderate income neighborhoods, consistent with the safe and sound operations of the bank."[17]

The OCC, in its white paper, states that it may offer guidance regarding activities that are considered to be innovative in terms of promoting financial inclusion.[18] While NCRC is not opposed to guidance of this nature, NCRC urges the OCC to promote only activities that are "innovative" in a CRA context if they effectively promote financial inclusion to substantial numbers of low- and moderate-income consumers in a responsible fashion. Such judgments cannot be subjective and must be grounded in careful data analysis.

Some have called for exceptions for FinTech firms to the Equal Credit Opportunity Act (ECOA), Fair Credit Reporting Act (FCRA), the Electronic Funds Transfer Act (EFTA), and other consumer protection laws, in so-called pilot experiments to allow FinTech firms time to develop new products. If new products cannot adhere to ECOA and other laws, they should not be introduced into the market. It is not innovative to develop products that result in discrimination or unfair and deceptive practices.

Ultimately, financial institutions will be innovative in serving low- and moderate-income consumers if they operate in a regulatory framework that applies uniform rules rigorously to all types of financial institutions. Financial institutions will then compete based on truly affordable products responsive to credit needs instead of grabbing market shares by promising quick approvals not grounded in careful underwriting or deceptive loan terms that feature adjustable rates that make loans initially affordable but then trap borrowers in unsustainable debt. In the wake of the financial crisis, Dodd-Frank mandated that the CFPB and prudential regulators promulgate the Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) rules that helped level the playing field for mortgage lenders by creating a uniform floor of prudent practices such as not lending beyond a borrower's ability to repay, and ensured that lenders had some "skin in the game" for faulty loan products. Similar rules are needed for FinTech and all other institutions, particularly those in consumer and small business lending.

Some initial efforts have been made to suggest best practices for marketplace lenders. Currently, advocacy organizations have been working with some FinTech companies to develop best practices such as those outlined in the Small Business Borrowers' Bill of Rights.[19] These include transparency and clarity regarding interest rates and loan terms and conditions. However, stronger oversight is required, including action by both regulators and Congress.

Conclusion

[17] OCC, *Charters: Controller's Licensing Manual*, Feb 2009, http://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/charters.pdf
[18] OCC, Supporting Responsible Innovation, p. 8.
[19] See http://www.responsiblebusinesslending.org/

NCRC considers innovation to be a large-scale provision of responsible loans that sustainably respond to credit needs. New technologies and new types of companies could be part of the answer but the romance with innovation should not blind us to the possibility that the new market entrants may not be the long term answer. NCRC believes that high-touch models will still be needed for reaching traditionally underserved populations; this may include counseling agencies partnering with both traditional lenders and FinTech companies. Data will be key to measuring success, creating rigorous enforcement, and public accountability. Only if comprehensive and uniform regulation is adopted and applied to both FinTech and existing companies will a lending marketplace be created that is responsible, efficient, and equitable.

Thank you for the opportunity to testify.

July 12, 2016

Testimony of

Rob Nichols

On Behalf of the

AMERICAN BANKERS ASSOCIATION

before the

Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

American
Bankers
Association

Testimony of

Rob Nichols

On behalf of the

American Bankers Association

before the

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Chairman Neugebauer, Ranking Member Clay, my name is Rob Nichols, and I am President and Chief Executive Officer of the American Bankers Association (ABA). The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, midsize, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend nearly $8 trillion in loans.

The topic of today's hearing is a timely one. New technologies are quickly changing the ways all businesses connect with their customers. "Fintech" is a term used to capture this convergence of banking and technology. While it has been used to refer to tech-focused startups, innovative technologies are offered by banks and startups alike. While many of these technologies may feel new, they typically leverage new technology as a delivery channel for traditional banking products and services.

Banks have always embraced innovation and continue to do so in order to better serve their consumers. Make no mistake, banks are pro-innovation, pro-consumer, and are very technology focused. Banks have pioneered important innovations in banking, such as ATMs, credit cards, online banking, and remote check deposit. Banks continue this innovation today, investing billions of dollars annually into technology to bring their customers the latest apps delivered through secure and trusted channels. Besides developing their own new products and apps, often through their own "innovation labs," banks are actively partnering with fintech startups to bring their customers the latest technologies.

When banks innovate and partner with startups to deliver new technologies their customers win. Many startups have developed innovative and intuitive platforms that give customers new ways to access to their financial services. Banks have a long history of serving customers needs and have established trusted relationships. These relationships are backed by a culture of compliance and regulatory oversight that ensures customers are protected. When innovative products are delivered through bank channels customers get a great experience backed with a relationship they can trust.

This is why the banking industry supports policies that empower banks to innovate and enable them to partner. If they are better able to integrate these technologies, customers will have greater access to safe, innovative technologies.

It is important to note that while technology can drive innovation and add value, it is not a replacement for a community presence. Community banking is a relationship business that is not replicable by technology. While banks are driving technological innovation, they remain a visible presence, supporting their local communities as they always have through community outreach and countless hours of volunteering – something that cannot happen through a key stroke or algorithm.

In my testimony today I will stress the following three points:

- Banks are innovating and partnering,
- When banks innovate customers win; and
- Innovation forward policies will benefit customers.

Financial technologies present tremendous opportunities to customers and banks alike. They have the potential to promote financial inclusion, giving greater access to financial services on better terms. They also have the potential to give customers better transparency into their financial services offerings and to enable the extension of credit to more creditworthy borrowers.

These benefits are only possible if we empower banks to innovate and partner with startups. Banks invest billions of dollars into innovations today that have the potential to benefit consumers and businesses. These innovations will only add value if banks, startups and regulators can collaborate. ABA stands ready to work with Congress and regulators to help facilitate this.

I. Banks are Innovating and Partnering

Today, banks of all sizes are innovating and partnering with technology-powered startups to deliver innovative products and services to their customers. Banks are investing significant resources into developing new technologies. They invest tens of billions of dollars annually into technology, much of which is devoted to new financial tools and apps. Security of customer information tops the list of investments, followed by data analytics, payment applications, and new mobile and online banking apps. A number of banks have established "innovation labs" to develop new products and apps. For example:

- A mutual bank in New England recently announced its "Express Business Loan," which allows small-businesses to apply for a loan, get approval, and receive funding all online and in less than three minutes.

- A parent company of a bank in the Northwest recently formed a collaborative bank innovation lab focused on advancing bank innovation.

Partnerships to Move Forward

Banks and startups both have a unique set of strengths. When the two collaborate they are able to deliver their customers the best, most innovative products through a trusted secure channel.

Fintech startups also bring a culture of innovation. Their technology expertise and ability to experiment has allowed them to build a digital customer experience without some of the constraints faced by banks.

Banks bring tremendous value to the table that is not replicable by startups, the most important being their role as trusted custodians of their customers' money and information. Banks have established a strong level of trust with customers that is necessary when handling someone's money. This trust is backed by a strong culture of compliance and a regulatory framework designed to protect customers. Establishing and growing customer relationships is the largest challenge for startups. Banks have stable deposit funding which gives them resiliency to offer innovative products throughout shocks and credit cycles.

Through collaboration and partnerships, banks and startups can deliver the best technology-forward products to customers. Examples of these partnerships include:

- **Small Business Lending** – One bank recently entered into a partnership with a marketplace lender to build a new small-dollar lending product for their small-business clients.
- **Consumer Lending** – A regional bank in the South partnered with a provider of personal loans to offer a "streamlined" online loan application and underwriting experience for their bank customers, and partnered with another firm to provide online loans to small businesses.

New Interface, Traditional Products

At their core, most innovations in financial services today closely resemble traditional banking products and services. The innovations being implemented today leverage new, digital delivery channels for these products to give customers faster, more convenient access to these traditional products.

Consumer and small business lending is critical to the American economy. Online lending is just a new delivery channel for a product that has existed for many years. ABA member banks have always provided consumer loans that help families reach their financial goals and the small business loans that drive local growth and job creation.

Marketplace lending is a catch-all term that typically describes online lending offered by non-banks. These lenders provide online interfaces that allow customers to apply for, and receive credit quickly and easily. They fund these loans in a number of ways. Although many lenders act as a "marketplace," matching borrowers with investors, many others originate loans that they hold to maturity. Moreover, a number of banks also offer online application and approval for loans.

The loans being originated by online non-bank lenders closely resemble traditional loans. They are typically fixed rate, term based (with maturities ranging from 36-60 months), and are fully amortizing (with the loan paid-off at the end of its set term).

Online lenders typically target traditional borrowers. Although online platforms have the potential to expand credit access, to date these platforms have done little to serve unserved or underserved borrowers. Lending Club, for example, has a minimum credit requirement that requires a FICO score of at least 660, with 78 percent of their loans being made for refinancing existing debt.

Relationship Banking Not Going Anywhere
While digital channels can add significant value for many customers, they are not for everyone. The high-touch relationship banking that banks, particularly community banks, offer are critical to communities across the country and are not replicable by technology.

A personalized approach allows banks to truly understand their customers and work with them, tailoring products to meet their specific needs. In his remarks on responsible innovation, Comptroller Curry noted concerns about customers relying solely on online lenders. "I would worry about the staying power of some of the new types of lenders. One of the great virtues of community banks is that they know their customers and they stand behind them in good times and bad. I'm not so sure that customers selected by an algorithm would fare as well in a downturn."

There are a number of communities with limited access to the technology needed to take advantage of online financial services. The Pew Research Center estimates that 68 percent of American adults have access to smartphones in 2015 with 85 percent having access to the internet. These statistics show significant progress, but we cannot forget about the 32 percent of Americans without smartphones and the 15 percent without internet access. These statistics become much more pronounced when looking at low income and rural communities. Community banks stand ready to serve these communities as they always have.

II. When Banks Innovate Customers Win

Innovation in financial services has the ability to benefit consumers across the country and drive growth in our economy. New technologies allow financial service firms to connect with customers in new ways and offer them products that may better fit their needs. It can lower the cost of financial services, making more affordable options available to consumers across the country. It provides added convenience and efficiency, giving customers the ability to manage their finances day or night from the palm of their hand. Technology can also lower the fixed costs for providing credit to small businesses, leading to greater capital access that spurs economic growth. As part of all of these innovations, banks continue to assure that customer information is protected.

Banks have served as a trusted provider of financial services for centuries and take that role very seriously, whether those services are provided in traditional channels or through new online and mobile applications.

Customer Protection Comes First

To customers, a loan is a loan. When making financial decisions, consumers expect the same level of protection regardless of the provider. Federal law provides for numerous protections for consumers when they borrow, and they expect this same level of protection in all financial services interactions.

Banks operate in a heavily regulated environment that ensures all new products are safe before they get into a customer's hands. Banks have robust risk controls around these products that ensure customers are protected. This culture of compliance leads to better outcomes for consumers. This strength equates to market confidence and builds trust.

Contrary to popular belief, the rules governing lending generally apply to banks and nonbanks alike. Consumer protection laws apply regardless of provider. Moreover, all small business loans are subject to a number of rules to ensure customers are treated fairly.

Despite these protections, it is impossible to deny that customers receive a different experience when they go to a bank versus a non-bank lender. Only 15 percent of small businesses who went to online lenders for financing in 2015 reported being satisfied with the lender compared to 75 percent satisfaction from those who went to banks. Top frustrations with non-banks were high interest rates (70 percent) and unfavorable repayment terms (51 percent).

The key differences leading to positive customer outcomes at banks are: (1) a long history of serving customers and the community; (2) a culture of regulatory compliance with regulations; and (3) effective oversight—including stringent and regular examination—by state and federal agencies proactively addressing concerns before customers are impacted negatively. Oversight would ensure more transparency in non-bank online lending that would lead to better outcomes for customers.

We urge policymakers not to apply new small business protections to both banks and non-banks and instead focus on the differences between the two that lead to very different outcomes, namely oversight. Today, online lenders comprise just 5 percent of the small business lending market. Problems that are emerging in the small percentage of online loans should not drive radical and unnecessary changes that risk impairing a market that has served business customers well for decades.

Today, there are a number of non-bank online lenders adhering to sound lending practices and serving their customers well. Constructive oversight will help them provide better service to their customers. Oversight also will identify and capture bad actors.

When banks partner with online lenders they ensure compliance with the many rules and regulations. Banks are required to fully vet all of their non-bank partners through third party vendor management guidelines. This relationship means that products offered in coordination with banks are often subject to greater oversight.

Fintech Charter

There is much discussion regarding whether there is a role for a non-bank federal charter. The OCC is conducting a careful analysis of the issues associated with this. As they proceed with this process we urge policymakers to consider the following points:

Charter Purpose – Regulators should examine the specific nature of the charter being requested and how it compares to an existing bank charter. The OCC has been given authority to charter federal institutions that serve a public purpose. The federal bank charter serves such public purposes today. Regulators need to consider how a proposed charter would differ from existing bank charter options and why a different regulatory approach is necessary. It should also examine whether those differences serve a public purpose.

A federal charter comes with a responsibility to continue serving a public purpose. Today banks have an obligation to serve the public good and demonstrate their performance (such as complying with the Community Reinvestment Act). Any non-bank charter should have an affirmative responsibility to meet their charter purpose and have similar standards of performance consistent with the public policy goals of the charter.

Consistent Protection – Any new charter must ensure that customers are adequately protected. When customers receive financial services they expect consistent levels of protection, regardless of the provider. Any such charter must provide the same level of consumer protection and oversight as a federal bank charter. It should not be considered a path to avoid regulation.

OCC Comptroller Curry is well aware of this issue, commenting that, "companies operating with a federal charter or in partnership with a federally chartered bank are sound and comply with basic consumer safeguards that apply to all creditors. I would be very concerned, for example, if we were to authorize a federal license that offers the benefits of the national bank charter, including preemption, without any of the safeguards or responsibilities that apply to banks and thrifts."

III. Innovation-Forward Policies Will Benefit Customers

Regulation Should Be Based on Activities

The nature of the activities that a company facilitates, not the company structure, is what matters. Good regulation helps identify and control for risks. Many innovations, at their core, are traditional banking products offered in new ways. By focusing on the activity taking place, regulators are best able to assess the risks being presented to consumers and the system.

Effective oversight can help financial providers identify compliance gaps before there is consumer harm. More importantly, oversight is needed to ensure that malicious actors do not take advantage of customers.

Partnership to Move Forward

A modern high-tech banking system requires a modern set of rules. Many laws and regulations were written well before today's technologies existed and will need to be updated to ensure they are true to their original intent by not omitting new technologies and delivery channels, and not restricting innovation by mandating specific technologies or limiting partnerships.

A Sandbox for Innovation

Many participants have suggested a "sandbox," that allows banks and non-banks to test new products, to help facilitate innovation in financial services. A sandbox is a broad analogy that means many things to many people. ABA believes that with the right parameters, a testing ground for new products can help facilitate innovation.

Greenhouse Approach – Although the term sandbox is commonly used to describe a testing ground for new products, a greenhouse is a better analogy. A sandbox is a playground that allows for experimentation with ideas that may have little real-world applicability. A greenhouse provides shelter for seedlings of ideas, giving them the right level of attention and care with a plan to introduce them to the real world as they develop. An effective testing ground for new products should facilitate development of products and services that have real world applicability with a development plan for a full roll-out to real customers.

New Products – A testing ground for new products only facilitates innovation if it allows companies to test new products in a way that they are unable to today. A program that only allows for piloting traditional products that banks have the authority to offer today risks adding another level of regulation which will prevent banks from introducing innovative products.

Our Vision – ABA believes that the creation of a "greenhouse" program – allowing companies to test new products on a limited scale – would facilitate innovation both inside and outside of the banking industry. A successful program would balance ensuring that participating customers are protected while limiting the compliance burden associated with testing a new product.

This program would require certain exemptions from existing compliance obligations. Today, implementing a full compliance program makes piloting many new products cost prohibitive. Participants in this program would work with regulators to develop rules and guidelines for the products covered. Customers would need to opt in and have full disclosure of the risks involved in a given product. Moreover, if customer harm is done, the individuals that were harmed must be made whole; however, participating banks should not be subject to sweeping fines as a result of programs that do not work as intended.

In practice this means that if, for example, a pilot did not meet customer needs, the program should be adjusted or canceled. The bank that piloted the program should have no further punishment for trying the product.

Conclusion

Financial technologies are quickly changing the way that customers connect with banks. These technologies have the potential to benefit consumers greatly, giving them better access to financial services on their terms. Banks are embracing this, developing new products and partnering with startups to deliver their customers the latest technologies. Customers benefit most when innovative products are delivered through safe, trusted channels. Smart policies will empower banks to innovate and partner to deliver the latest technologies to customers.

Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
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"Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending"

Testimony of Bimal Patel

Chairman Neugebauer, Ranking Member Clay, and Members of the Subcommittee, it is an honor to testify before you today about the development of online marketplace lending. My name is Bimal Patel. I am currently a Partner and Head of the Financial Advisory and Regulation Practice at O'Melveny & Myers LLP. Immediately prior to re-joining O'Melveny, I served from 2012-2015 as Senior Advisor to Jeremiah O. Norton, then a member of the Board of Directors of the Federal Deposit Insurance Corporation. Since returning to the private practice of law, I have advised banks, online lending platforms, and investors on regulatory and commercial issues related to the operation of marketplace and alternative lending platforms.

My written testimony will proceed in several parts. First, I will provide a brief overview of online marketplace lending business models. Second, I will describe the market penetration and opportunity of marketplace lending based on publicly-available statistics. Third, I will then discuss some of the factors that have been identified as fueling the growth of online lending. Fourth, I will identify some of the statutes and regulations that currently apply to various online lending models. Finally, I will explain some regulatory considerations and recent developments that will shape the continuing development of this industry.

Introduction to Online Marketplace Lending

According to the U.S. Department of the Treasury in its recent white paper on online marketplace lending, "[o]nline marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers."[1] Within this broad framework, marketplace lending business models vary considerably, focusing on different customer segments with

[1] U.S. DEP'T OF TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, May 10, 2016, at 5, https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf

different operational and underwriting models. One key point of distinction within marketplace lending models centers on whether a particular marketplace lender partners with a bank in its origination process. As described more fully below, federal law permits banks to "export" their home state rate of interest to all borrowers regardless of the state in which a borrower resides.

Consequently, loans originated by banks whose home state have no effective usury limitation—a limitation on maximum interest rates—can carry higher interest rates than loans originated by other banks and non-bank lenders. Thus, some marketplace lending business models depend on such a partnership to enable them to underwrite loans at rates that would otherwise violate state usury laws. Such a partnership is generally most advantageous in the context of consumer lending because state usury laws tend to be most restrictive with respect to these loans. Consumer marketplace lenders such as LendingClub and Prosper utilize bank partnerships in origination. As an alternative to partnering with a funding bank, marketplace lenders can engage in lending by procuring state lending licenses in the states in which they make loans, but these loans are subject to state law interest rate restrictions that vary by state and pose administrative and financial burdens that can be prohibitive to certain business models.

The cornerstone on which marketplace lending businesses are built is the marketplace lender's online platform, which should be designed to facilitate efficient matching of borrowers and investors. The typical lifecycle of a marketplace loan is as follows: First, a borrower applies for a loan on the lender's online platform, a secure website where prospective borrowers can provide information about: (1) the size of the loan requested; (2) how the borrower intends to use the funds; and (3) the borrower's current finances. Using an automated algorithm, the lender then determines whether the loan request satisfies the criteria of the platform and, if so, the payable interest rate and fees of each loan, based on information such as (but not necessarily) the borrower's FICO score, the size of the loan, the borrower's debt-to-income ratio, the borrower's self-reported income, and the borrower's employment history and trajectory. The marketplace lender then posts the loan request onto the platform for consideration by the platform's registered prospective investors. Once a borrower and investor have accepted the loan terms, the marketplace lender originates the loan or collects an origination fee and arranges for the loans to be originated at a partner bank or originates the loan itself. If the loan is originated by a partner bank, the marketplace lender then purchases the loan from the partner bank. Then, the marketplace lender will transfer the loan to the investors, often via a securitization process in the form of notes registered with the Securities and Exchange Commission.

While marketplace lenders operate differing business models for differing customer segments, many share some or all of the following characteristics:

- ***User-friendly online experience***: Most marketplace lenders use online platforms to reach their customers and investors, and can provide a prospective borrower with a loan offer at the near-instant speeds which online customers have come to expect, rather than the weeks it takes to apply through a bank lender.

- ***Non-traditional funding***: While many marketplace lenders still rely on a peer-to-peer model in which a significant portion of their fund derives from selling pass-through notes to retail investors as described above, marketplace lenders possess a diverse set of non-traditional funding mechanisms including equity investments, private placements, whole loan sales to institutional investors, and lines of credit from institutional investors.

- ***"Balance sheet light"***: Many marketplace lenders do not keep loans on their balance sheets. Instead, these marketplace lenders collect origination and service fees from arranging loans, which are sold shortly after origination, either to individual investors or in the form of securities. In doing so, marketplace lenders are able to provide loans to prospective borrowers without exposure to credit risk or keeping capital tied up in loans.

- ***Alternative credit decisioning models***: Many marketplace lenders base their formation on leveraging alternative credit models to identify underserved or undervalued segments of borrowers or mispriced credit. In many cases, marketplace lenders still use FICO scores as the primary driver of underwriting decisions, but in many cases the very purported advantage of a marketplace lending business lies in its alternative underwriting methodology. SoFi is a prominent example and has funded over $7 billion in student, home, and personal loans[2] using a proprietary credit decisioning algorithm, which as of early 2016 completely abandons the use of FICO scores in underwriting.[3] As described below, these credit decisioning models might bring additional regulatory and compliance considerations into play, particularly with respect to fair lending.

Market Penetration and Size

Estimates of the size of loan originations by marketplace lenders in the U.S. vary, but recent data released by the California Department of Business Oversight ("DBO") provide a good starting point for determining the current state of the online lending industry. The DBO collected data from 13 of the largest online marketplace and alternative lenders,[4] which it published in an April 2016 report.[5] According to the DBO report, the aggregate volume of loan originations made by the 13 respondents in 2014 was $15.91 billion, up from $1.99 billion in 2010, marking an increase of 699.5%.[6] Data

[2] Leena Rao, *This Bank Wants to Be Your Best Friend*, FORTUNE, Mar. 19, 2016, at 68.
[3] Peter Rudegeair, *Silicon Valley: We Don't Trust FICO Scores*, WALL STREET J., Jan. 11, 2016, http://www.wsj.com/articles/silicon-valley-gives-fico-low-score-1452556468?tesla=y.
[4] The 13 respondents to the California DBO's Survey of Online Consumer and Small Business Financing Companies were Affirm, Avant, Bond Street, CAN Capital, Fundbox, Funding Circle, Kabbage, LendingClub, OnDeck, PayPal, Prosper, SoFi and Square.
[5] CAL. DEP'T OF BUSINESS OVERSIGHT, SURVEY OF ONLINE CONSUMER AND SMALL BUSINESS FINANCING COMPANIES —01/01/2010 THROUGH 06/30/2015: SUMMARY REPORT OF AGGREGATE TRANSACTION DATA, http://dbo.ca.gov/Press/press_releases/2016/Survey%20Response%20Summary%20Report%2004-08-16.pdf
[6] *Id.* at 2.

for the first half of 2015 reflect originations of $12.47 billion.[7] These figures include term loans, but also lines of credit, merchant cash advances, factoring transactions and other products. Other estimates of the volume of loan originations by online marketplace lenders for 2015 range from $15 billion to nearly $40 billion.[8]

To date, the substantial majority of this activity has taken place in the consumer lending arena, with small business lending also seeing significant activity. Increasingly, online marketplace lenders are serving broader market segments including education lending, auto lending, and mortgage lending. Indeed, growth rates for online marketplace loan volume origination are impressive. Yet, these loans continue to represent a small percentage of the total addressable market for consumer and business loans in the U.S. Data cited by the Department of the Treasury suggest that the total addressable market for U.S. credit (excluding mortgage credit) exceeds $1 trillion dollars.[9] The total volume of online marketplace lending appears even smaller relative to the $3.5 trillion U.S. consumer lending market.[10] Recent data with respect to small business lending underscore the opportunity for online marketplace lending to address unmet demand in this market as well. According to a recent Harvard Business School Working Paper citing data from the Federal Reserve Bank of New York:

> [A]bout 37 percent of all small businesses applied for credit in the fall of 2013. About 45 percent did not apply, presumably because they did not need credit, but about 20 percent did not apply because they were discouraged from doing so, either because they felt that they would not qualify or because they thought the process would be too arduous to justify the time commitment. Of businesses that did apply, over 40 percent either received no capital at all or received less than the amount that they requested. This underscores the manner in which seeking bank credit can be difficult, though not necessarily impossible, for many small businesses to secure.[11]

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[7] *Id.*

[8] *See* Rudegair, *supra* n. 3 ($37 billion); *see also* CAMBRIDGE CENTRE FOR ALTERNATIVE FINANCING, UNIVERSITY OF CAMBRIDGE JUDGE BUSINESS SCHOOL, BREAKING NEW GROUND: THE AMERICAS ALTERNATIVE FINANCE BENCHMARKING REPORT (2016) at 24https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2016-americas-alternative-finance-benchmarking-report.pdf (above $30 billion); DELOITTE, MARKETPLACE LENDING - A TEMPORARY PHENOMENON? (2016) at 4, https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-marketplace-lending.pdf ($23 billion); Marketplace Lending, in 2015 - A Year of Performance and Growth, Dec. 28, 2015, http://www.pmifunds.com/marketplace-lending-in-2015-a-year-of-performance-and-growth/ ($18 billion)

[9] DEP'T OF TREASURY, *supra* n.1, at 9; *see also* HEATH P. TERRY ET AL., GOLDMAN SACHS, THE FUTURE OF FINANCE: THE SOCIALIZATION OF FINANCE, at 4 exhibit 2 (2015).

[10] Board of Governors, Federal Reserve System, *Consumer Credit Outstanding* (Jan. 2016), https://www.federalreserve.gov/releases/g19/20160307/.

[11] Karen G. Mills and Brayden McCarthy, *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (Harvard Business School Working Paper, No. 15-004, July 2014) at 23.

Currently, there are dozens of online lenders across consumer, business, and student lending in the U.S. The online marketplace lending market, however, remains concentrated, with a small number of firms generating a substantial share of loan originations within each respective market segment.

What Has Caused the Growth in Marketplace Lending Volume?

Several factors have contributed to a perfect storm that has borne rapid growth among marketplace and alternative lenders.

Low Interest Rate Environment

In the wake of the financial crisis, investors were challenged to find returns in an unprecedented low-interest environment.[12] Between December 16, 2008 and December 17, 2015 the Federal Open Market Committee kept its target federal funds rates at near zero for a period of 84 months.[13] At the same time, many consumers burdened with high-interest debt sought to refinance their loans at more manageable interest rates.[14] This presented an opportunity to link borrowers seeking lower rates with investors seeking higher yields.

Against this backdrop, many investors turned to marketplace lending as a means to obtain higher returns by funding loans to online borrowers. According to one index, marketplace lending in the aggregate provided a net annual return of 6.84 percent in 2015.[15] For the year ending December 2015, marketplace lenders LendingClub and Prosper boasted average returns of 5.25 percent to 8.57 percent[16] and 4.34 percent to 11.44 percent,[17] respectively. In addition to receiving higher average annual returns, investors at marketplace lenders like LendingClub and Prosper also enjoyed the ability to select their preferred level of risk and diversify their portfolios by funding many different loans to borrowers of varying creditworthiness. Today, even though interest rates are no

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[12] Currently, five-year Treasury bonds offer yields of less than one percent, and seasoned AAA corporate bonds offer less than four percent. U.S. DEP'T OF TREASURY, *Daily Treasury Yield Curve Rates*, https://www.treasury.gov/ resource-center/data-chart-center/interestrates/Pages/TextView.aspx?data=yield (last updated Jul. 8, 2016); *see also* MOODY'S, *Moody's Seasoned Aaa Corporate Bond Yield*, https://ycharts.com/indicators/moodys_seasoned_aaa_corporate_bond_yield (last updated Jul. 7, 2016).
[13] BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, *Open Market Operations: FOMC's Target Federal Funds Rate or Range, Change (basis points) and Level (2008-2015)* (Dec. 16, 2015), https://www.federalreserve.gov/monetarypolicy/ openmarket.htm.
[14] Bloomberg, Mortgage Bankers Association Refinancing Index (SA), http://www.bloomberg. com/chart/icJsdXbuXYxM (last visited June 10, 2016).
[15] The Orchard US Consumer Marketplace Lending Index tracks the performance of the aggregate amount of loans to consumers originated and funded on eligible US-based online lending platforms. Orchard, Orchard US Consumer Marketplace Lending Index (2011-2015), https://www.orchardindexes.com/ (last visited June 10, 2016); *see also* Tom Anderson, *More Investors Turn to P2P Lenders for High Yield*, CNBC, Aug. 28, 2015, http://www.cnbc.com/ 2015/08/28/more-investors-turn-to-p2p-lenders-for-high-yield.html.
[16] *Investing: Earn Solid Returns*, LENDINGCLUB, https://www.lendingclub.com/public/steady-returns.action (last visited June 10, 2016).
[17] *Why Invest with Prosper?: Competitive Returns*, PROSPER, https://www.prosper. com/invest (last visited Mar. 29, 2016).

longer at their lowest point, the promise of greater returns continues to draw investors to fund loans originated via marketplace lending platforms.

Interest Rate Exportation

In 1978, the Supreme Court clarified that the National Bank Act, as codified in 12 U.S.C. § 85, and the constitutional supremacy of federal law over state law allow banks to "export" interest rates across state lines. Under the current regime, the maximum interest rate that a bank can charge on loans is determined by the laws of the state in which the bank is located, as opposed to the state in which a borrower resides. In *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, the Supreme Court held that state usury laws could not be the basis of claims against nationally-chartered banks located in other states as long as those banks complied with federal law.[18] The Court held that the National Bank Act[19] preempted state law in this area. Later, in 1980, Congress amended the Federal Deposit Insurance Act by adding a new section granting State-chartered insured banks the same right to charge out-of-state customers any interest rate that would be allowed under the laws of the bank's home state.[20]

Internet-based marketplace lenders benefit from this regime as well. To the extent marketplace lenders elect to originate loans through partner banks located in states with unrestrictive interest rate caps, marketplace lenders are able to offer loans that might be uneconomical under the laws of a borrower's home state. In fact, some marketplace lenders have specialized in offering loans to a segment of higher-risk borrowers that might be underserved if bound by restrictive usury laws.[21]

The ability to underwrite and offer loans without being subject to state interest rate restrictions remains central to many marketplace lending models. It is important to note, however, that a recent decision by the U.S. Court of Appeals for the Second Circuit has raised fresh questions about the legal viability of such a model. Specifically, in *Madden v. Midland Funding, LLC*, the court held that the interest rate exportation provision of the National Bank Act, 12 U.S.C. § 85, could not be invoked by a non-national bank assignee.[22] The U.S. Supreme Court recently declined to review the

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[18] 439 U.S. 299 (1978).
[19] Under the National Bank Act, "Any association may take, receive, reserve, and charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more . . . ." 12 U.S.C. § 85.
[20] "In order to prevent discrimination against State-chartered insured depository institutions. . . such State bank or such insured branch of a foreign bank may . . . charge on any loan or discount made . . . interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank or such insured branch of a foreign bank is located or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater." *Id.* § 1831d(a).
[21] Alan Zibel and AnnaMaria Andriotis, *Lenders Step Up Financing to Subprime Borrowers*, WALL STREET J., Feb. 18, 2015, http://www.wsj.com/articles/lenders-step-up-financing-to-subprime-borrowers-1424296649.
[22] 786 F.3d 246 (2d Cir. 2015).

Second Circuit's decision,[23] and if this line of reasoning is applied to loans originated through online marketplace lending channels, this precedent might put a partner bank origination model at risk if marketplace lenders lose rate exportation benefits upon purchase or assignment of loans.[24] In fact, marketplace lenders have recently begun to modify agreements with partner banks to try to ensure that partner banks retain an ongoing economic interest in loans and remain the true lender for loans.[25]

Institutional Support

In the face of the low interest rate environment, institutional investors too face a dilemma in realizing appropriate yields. Many have turned to marketplace lending as a means to tap into several profitable lending markets, including those for personal loans, small business loans, real estate loans, and student loans.

Institutional investors have played a major role in marketplace lending by purchasing the loans originated by marketplace lenders. This demand for loans is what fueled the marketplace lending model, freeing up capital for the lenders to continue to generate additional loans. According to a 2015 PriceWaterhouseCoopers report, institutional investors provided about 80 percent of the funding on the peer-to-peer subset of marketplace lending.[26] Without the support of institutional investors willing to purchase loans as quickly as marketplace lenders could generate them, the lenders would likely not have been able to generate the large value of marketplace loans that have been originated to date.

In addition, institutional investors have supported marketplace lenders at the point before a single loan is originated. Institutional investors have become a key source of start-up funding for the newest generation of marketplace lenders, providing borrowers with an ever-growing list of borrowing alternatives.[27] In 2015, SoFi raised over $1.25 billion from Softbank Group Corp., based in Japan, and Third Point Ventures, based in New York.[28] In just one week, five different marketplace lenders received over $500 million in venture capital to provide loans targeting small businesses, consumers, and

[23] The U.S. Supreme Court denied a pending petition for certiorari declining review of the case on June 27, 2016. No. 15-610, 2016 WL 3461580 (U.S. June 27, 2016).
[24] Some sources report that investors have begun to avoid loans originated within the Second Circuit, which decided *Madden*, which could have significant implications for marketplace lending platforms as well as borrower access to credit in the subject states *See* Kadhim Shubber, *The Online Lending Lie*, FIN. TIMES: ALPHAVILLE (Feb. 4, 2016), http://ftalphaville.ft.com/2016/02/04/2152142/the-online-lending-lie/.
[25] *See, e.g.*, LendingClub Corp., Current Report (Form 8-K), at § 2, sched. 2(i) (Feb. 25, 2016), *available at* http://ir.lendingclub.com/Cache/33197558.pdf?IID=4213397&FID=33197558&O=3&OSID=9 (Ex. 10.1, Loan and Receivable Sale Agreement between WebBank and LendingClub Corp).
[26] PWC, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CUSTOMER LENDING INDUSTRY 3 (Feb. 2015), http://www.pwc.com/us/en/consumer-finance/publications/peer-to-peer-lending.html.
[27] For example, since 2010, Victory Park Capital has invested more than $2.2 billion across a number of marketplace lending firms. Press Release, Victory Park Capital, Victory Park Capital and KKR Lead an Inaugural $175 Million Asset-Backed Securitization of Avant Consumer Loans (Nov. 19, 2015), http://victoryparkcapital.com/2015/ November-19.html.
[28] Dan Primack, *SoFi Raises Whopping $1 Billion to Refinance Student Loans*, FORTUNE, Sept. 30, 2015, http://fortune.com/2015/09/30/sofi-raises-whopping-1-billion-to-refinance-studentloans/.

clean energy.[29] For the moment, it seems that there are strong tailwinds aiding those looking to secure the funding to design and operate an online lending platform.

Statutes and Regulations Potentially Applicable to Online Marketplace Lending

Federal and state regulation and compliance considerations affect the marketplace lending business at all points during the lifecycle of a marketplace lending transaction. The following is a summary of the federal and state statutes and implementing regulations for which compliance obligations might attach.

- ***The Equal Credit Opportunity Act*** ("ECOA")[30] prohibits creditors from discriminating against prospective borrowers on the basis of any of the following: race, color, sex, age, religion, national origin, marital status, percentage of income derived from public assistance programs, or prior history of exercising in good faith any right under the Consumer Credit Protection Act or any applicable state law. Marketplace lenders and partner banks as applicable engaging in some form of underwriting must take care to comply with ECOA's prohibitions on discrimination.
- ***The Bank Secrecy Act*** ("BSA"),[31] as implemented through various regulations, is the primary federal anti-money laundering statute and requires any financial institution making loans to implement policies and procedures to: (1) engage in customer identification procedures; (2) identify and reject any customers who are known or suspected terrorists or are engaged in money laundering activities or prohibited transactions; (3) report suspicious activity; and (4) share anti-money laundering information with relevant government authorities.[32] BSA requirements apply to partner banks when applicable and might apply to marketplace lenders themselves if those marketplace lenders fall within the definition of a "financial institution" under applicable law.
- ***The Fair Credit Reporting Act*** ("FCRA")[33] governs the use of "consumer reports," and imposes numerous restrictions and requirements on any companies that access them in the course of business. Many marketplace lenders use consumer reports to determine the credit risk of prospective borrowers, and must take care to comply with the numerous use, notice, disclosure, and privacy requirements imposed by the FCRA.

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[29] Aliza Hornbass, *Top 5 FinTech Rounds: Marketplace Lenders Keep Piling Up Capital*, BANK INNOVATION, July 27, 2015, http://bankinnovation.net/2015/07/top-5-fintech-roundsmarketplace-lenders-keep-piling-up-capital/.

[30] 15 U.S.C. § 1691 *et seq.*; 12 C.F.R. § 1002.2(z) ("Prohibited basis means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Bureau.").

[31] 31 U.S.C. § 5311 *et seq.*

[32] *Id.* § 5318 (g), (k), (l).

[33] 15 U.S.C. § 1681 *et seq.*

- ***The Truth in Lending Act*** ("TILA"),[34] as implemented by Regulation Z,[35] requires all lenders to provide consumers with a uniform set of disclosures containing information about the terms and conditions of their loan, including interest rates and finance charges. TILA requirements apply to partner banks or to marketplace lenders themselves if they lend via state lending licenses.

- ***The Electronic Funds Transfer Act*** ("EFTA"),[36] as implemented by Regulation E,[37] establishes the rights, liabilities, and responsibilities of persons engaged in electronic funds transfers. The EFTA requires companies to obtain written authorization from a consumer before automatically debiting the consumer's account in connection with a payment. The EFTA also prohibits lenders from requiring borrowers to make payments electronically. EFTA requirements can apply to partner banks and marketplace lenders themselves depending on their respective roles in lending transaction flows.

- ***The Electronic Signatures in Global and National Commerce Act*** ("E-Sign Act"),[38] sets forth the requirements that must be followed in order for an electronic signature to be considered valid, such as reserving the rights of individuals to use a paper signature and requiring certain disclosures. Because marketplace lenders conduct the vast majority of their activities online, they must carefully follow the requirements of the E-Sign Act in order to ensure that any loan documentation completed online will be considered valid.

- ***The Securities Act of 1933*** ("Securities Act")[39] requires any issuer offering its securities to the public to register its securities with the SEC unless a specific exemption applies. Many marketplace lenders, including LendingClub and Prosper, have gone through the process of registering their securities with the SEC. The Securities Act also gives investors a cause of action against companies that provide inaccurate or misleading information to investors. Marketplace lenders face potential liability under this provision for any false or misleading information they provide, as well as any false or misleading information which borrowers provide that the marketplace lender passes on to investors through its platform.

- ***State Laws*** Many states have laws imposing various licensing requirements on brokers, lenders, and debt collectors, as well as other laws governing usury limits, and advertising. Levels of regulation and enforcement vary from state-to-state, potentially imposing a heavy compliance burden on marketplace lenders which

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[34] *Id.* § 1601 *et seq.*
[35] 12 C.F.R. § 1026.
[36] 15 U.S.C. § 1693 *et seq.*
[37] 12 C.F.R. § 1005.
[38] 15 U.S.C. § 7001 *et seq.*
[39] 15 U.S.C. § 77a *et seq.*

offer loans to borrowers in all 50 states. For example, each state has its own "blue sky law" requiring the registration of all securities offerings and sales, which could apply to the sale of participation notes by marketplace lenders that are not "covered securities" under the National Securities Market Improvement Act of 1996 ("NMSIA").[40] Furthermore, marketplace lenders must be cognizant of recent case law that might be construed to require marketplace lenders to fulfill licensing requirements under state law.[41]

Regulatory Considerations and Developments

The statutes and regulations discussed above can apply to online marketplace lenders either directly or indirectly through partner originating banks for those that utilize a bank partner.

There are many legal paths through which marketplace lenders might be subject to direct supervision by regulators at various points in the transaction lifecycle. One point at which marketplace lenders have already encountered compliance difficulties involved registration requirements of notes offered to investors in connection with loans originated via LendingClub and Prosper.[42] With respect to many of the consumer protection statutes and regulations identified above, marketplace lenders might also be subject to supervision and examination as a "Larger participant" in a consumer financial market or as a "service provider" to a bank or other person who engages in the offering or providing of a consumer financial product or service.[43] Indeed, the *Wall Street Journal* has reported that the CFPB plans to begin directly supervising Marketplace Lenders as soon as late 2017.[44] Additionally, on March 7, 2016, the CFPB established an online complaint portal for marketplace lending[45] and issued guidance to consumers regarding

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[40] The NMSIA preempts the registration and qualification requirements of state blue sky laws with regards to "covered securities." *Id.* § 77r.

[41] *See, e.g.*, Memorandum Opinion, *Pa. Dep't of Banking and Sec. v. Autoloans, LLC*, No. 566 M.D. 2015 (Pa. Commw. Ct. Jan. 22, 2016) (upholding a cease and desist order against an out-of-state internet lender for charging rates of interest in excess of those allowed for an unlicensed lender); Opinion, *Maryland Comm'r of Fin. Regulation v. CashCall, Inc.*, 225 Md. App. 313 (2015) (upholding civil money penalty imposed by Maryland Commissioner of Financial Regulation because CashCall was engaged in the business of arranging consumer loans without being licensed).

[42] For example, in 2008, both LendingClub and Prosper went through a "quiet period," and ceased all new lending until completing the security registration process with the SEC. *Lending Club Completes $600 Million SEC Registration and Offers New Alternative for Consumer Credit*, LENDINGCLUB, http://blog.lendingclub.com/ lending-club-sec-registration/ (last visited June 10, 2016); *Prosper.com Reopens for Lending*, N.Y. TIMES ON THE WEB: DEALBOOK, http://dealbook.nytimes.com/ 2009/04/28/ prospercom-reopens-for-lending/ (last visited June 10, 2016).

[43] 12 U.S.C. § 5481(26).

[44] Rachel Witkowski, *Consumer Finance Watchdog Plans to Supervise Marketplace Lenders*, WALL STREET J., Apr. 27, 2016, http://www.wsj.com/articles/consumer-finance-watchdog-plans-to-supervise-marketplace-lenders-1461794493.

[45] Press Release, Consumer Fin. Protection Bureau., CFPB Now Accepting Complaints on Consumer Loans From Online Marketplace Lender,
Mar. 7, 2016, http://www. consumerfinance.gov/newsroom/ cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender/.

marketplace lending.[46] Furthermore, specific statutes might provide for direct liability for marketplace lenders depending on the context of the transactions in which claims arise, such as assignee liability under TILA.[47] And, if a marketplace lender is deemed a "financial institution" under applicable BSA/AML regulations, it would be responsible for compliance with these regulations. Finally, marketplace lenders might be subject to direct regulation or supervision under state law and have already begun garnering significant interest from state regulators in that regard.[48]

Regulators have recently underscored their expectation that banks monitor their third-party relationships in a similar manner to which they would monitor activities in which they would engage themselves. Recently, Comptroller Thomas J. Curry has even suggested that FinTech companies who partner with national banks or federal savings associations should be subject to the same safety and soundness and consumer compliance obligations as partner banks: "[C]ompanies operating with a federal charter or in partnership with a federally chartered bank [should be] sound and comply with basic consumer safeguards that apply to all creditors. I would be very concerned, for example, if we were to authorize a federal license that offers the benefits of the national bank charter, including preemption, without any of the safeguards or responsibilities that apply to banks and thrifts."[49] These remarks accompanied new guidelines on responsible innovation in the federal banking system that the OCC issued for comment in March 2016.[50] Previously, in discussing third-party relationships more generally, the OCC advised banks of that "[t]he Office of the Comptroller of the Currency (OCC) expects a bank to practice effective risk management *regardless of whether the bank performs the activity internally or through a third party*. A bank's use of third parties does not diminish the responsibility of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws." (emphasis added).[51] The FDIC has issued similar comments specifically aimed at banks partnering with marketplace lenders:

> Bank management is encouraged to develop a strong understanding of the marketplace lending company's business model, establish contractual agreements that protect the bank from risk, regularly monitor the

[46] CONSUMER FIN. PROTECTION BUREAU, UNDERSTANDING ONLINE MARKETPLACE LENDING 1-2 (2016), http://files.consumerfinance.gov/f/201603_cfpb_understanding-online-marketplace-lending.pdf
[47] 15 U.S.C. § 1641.
[48] Ruth Simon, *California Regulator Launches Inquiry Into Marketplace Lenders*, WALL STREET J., Dec. 11, 2015, http://www.wsj.com/articles/california-regulator-launches-inquiry-into-marketplace-lenders-1449810242.
[49] Thomas J. Curry, Comptroller, Office of Comptroller of Currency, Remarks Before the Harvard Kennedy School's New Directions in Regulation Seminar at 7 (Mar. 31, 2016), http://www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-39.pdf.
[50] OFFICE OF THE COMPTROLLER OF THE CURENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE (Mar. 31, 2016), http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-systemocc-perspective.pdf.
[51] OCC Bulletin 2013-29: Third Party
Relationships (Oct. 30, 2013), http://www.occ.gov/news-issuances/ bulletins/2013/bulletin-201329.html (emphasis added).

> marketplace service provider, and require the marketplace lending company to take corrective action when gaps or deficiencies occur. This due diligence may result in banks requiring policies and procedures from the marketplace lending company with respect to legal and regulatory compliance prior to the bank's investment or before any services are offered. Some considerations include, but are not limited to, compliance with applicable federal laws such as lending laws, consumer protection requirements, anti-money laundering rules, and fair credit responsibilities along with adherence to any applicable state laws, licensing, or required registrations.[52]

Thus, marketplace lending models that use partner banks are not relieved from regulatory compliance obligations; rather, these obligations remain the responsibility of partner banks. This enhanced emphasis should lead partner banks to engage in the monitoring called for by the regulators as well as impose contractual obligations on their marketplace lender partners to facilitate data collection and compliance with the operative regulations.

Recently, the OCC has publicly discussed that it is considering whether to offer a national bank charter for online marketplace lenders or even some form of a more limited purpose charter for these entities.[53] These considerations are in their nascent stages but, if calibrated appropriately, could accelerate innovation and economic growth.

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Again, I thank the Committee for the opportunity to discuss these matters, and I welcome your questions.

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[52] Angela M. Herrbolt, Division of Risk Management, Federal Deposit Insurance Corp., *Marketplace Lending*, SUPERVISORY INSIGHTS at 15–16 (Winter 2015), https://www.fdic.gov/ regulations/examinations/ supervisory/insights/siwin15/SI_Winter2015.pdf.

[53] Lalita Clozel, *OCC Weighs New Charter for Fintech Firms*, AM. BANKER, May 9, 2016, http://www.americanbanker.com/news/law-regulation/occ-weighs-new-charter-for-fintech-firms-1080908-1.html.

Testimony of Parris Sanz
Chief Legal Officer, CAN Capital, Inc.

Before the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit

"Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending"

July 12, 2016

Chairman Neugebauer, Ranking Member Clay, and Members of the Subcommittee:

I am honored to appear before the Subcommittee today on behalf of CAN Capital and the Electronic Transactions Association ("ETA") to discuss the critical role online lending can play in expanding access to credit to our nation's small business owners.

About CAN Capital

Founded in 1998 by a woman small business owner who sought to solve the problem of small business access to capital, CAN Capital is the longest tenured and largest alternative small business finance company. CAN Capital currently employs approximately 450 employees and has provided access to over $6 billion of capital to our small business customers in more than 175,000 separate transactions. The Company provides access to as much as $250,000 per business location, although most customers seek $100,000 or less, and the average transaction size is approximately $45,000. The Company has served small businesses in hundreds of different industries, including healthcare, food retail, automotive, construction, spas and beauty, and business equipment and services, among others. For over 18 years, CAN Capital has served the Main Street businesses that account for half of the private sector workforce and two out of every three new jobs created in the last two decades.[1]

About ETA

ETA is the leading trade association for the payments industry, representing over 500 companies that offer electronic transaction processing products and services, including financial institutions, transaction processors, payments networks, and others. ETA members make commerce possible by processing more than $6 trillion in purchases in the U.S. and deploying payments innovations to merchants and consumers. ETA also has members that are engaged in online lending for commercial enterprises, primarily small businesses, either directly or in partnership with other lenders.

[1] Joint Small Business Credit Survey Report, 2014, Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia (released February 2015) at 4 ("Joint Small Business Credit Survey"); Karen Gordon Mills, Brayden McCarthy, The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game, Harvard Business School Working Paper 15-004 (July 22, 2014) at 24 ("State of Small Business Lending").

Problems with Small Business Access to Credit

Access to capital is the lifeblood of small businesses and a major determinant of their success or failure. Unlike larger businesses, small businesses do not typically have access to the capital markets and are heavily dependent upon bank financing.[2] Even when bank lending to small businesses was at its apex, from 2005 through 2007, more than 50% of small and midsized businesses reported difficulties obtaining sufficient credit.[3] Thereafter, the financial crisis virtually shut down almost all bank lending to small businesses. More than eight years later, challenges still exist for many small businesses to obtain the credit they need from traditional small business loans. According to a 2014 Federal Reserve survey "a majority of small firms (under $1 million in annual revenues) and startups (under 5 years in business) were unable to secure any credit in the prior year".[4] That is a huge gap in credit availability that leaves many small businesses struggling, with significant adverse implications for the economy as a whole.

The problem is especially acute for small businesses seeking smaller loan amounts. Loans of $100,000 or less account for 90% of small business loans.[5] According to the same 2014 Fed survey mentioned above, more than half of the small businesses surveyed that applied for credit in 2014 were seeking loans of $100,000 or less.[6] Among small business applicants with less than $1 million in annual revenues, more than half of them received less than 50% of the amount for which they applied.[7] This lack of access to smaller loans adversely affects the ability of small businesses to pursue growth opportunities or hire new employees.

Traditional lenders have been unable to effectively address the needs of small businesses because of high customer acquisition and underwriting costs, outmoded and cumbersome underwriting methods and overhead costs associated with their brick and mortar branches. As the Department of Treasury noted in its recent request for information ("RFI") on online and marketplace lending, traditional small business lenders have "high search, transaction and underwriting costs ... relative to potential revenue - it costs about the same to underwrite a $5 million dollar loan as a $200,000 loan - and many small business owners report they are unable to access the credit needed to grow their business".[8] Because of the disproportionately high costs of originating small business loans, it can be uneconomical for many banks and other financial institutions to make loans to many small businesses in amounts less than $150,000, $250,000 or even $1 million dollars. As a result, such institutions have not largely focused on the small business lending market and the percentage of bank loans made to small businesses has dropped to record low levels. In 1995, small business loans accounted for 50% of all bank loans. By 2012, this number had declined to 30%.[9] Foreseeably, the continuing consolidation in the banking industry may result in even less traditional bank lending to small businesses.

[2] Small businesses receive 95% of their financing from banks. 2011 Economic Report of the President, Council of Economic Advisors, The White House.
[3] Experian Information Solutions, Quarterly Business Credit Review for Q3 2013, December 10, 2013, citing NFIB Small Business Optimism Survey, Moody's Analytics, 2013.
[4] Joint Small Business Credit Survey at 4.
[5] Office of Advocacy, Small Business Lending in the United States 2013, Victoria Williams, U.S. Small Business Administration, 2014.
[6] Joint Small Business Credit Survey at 4.
[7] Ibid at 14.
[8] 80 FedReg. 42866, 42867 (July 20, 2015), citing The Future of Finance, Goldman Sachs Equity Research, March 3, 2015.
[9] Karen Gordon Mills, Brayden McCarthy, The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game, Harvard Business School Working Paper 15-004 (July 22, 2014) at 24 ("State of Small Business Lending").

Even where a bank's minimum loan amount may be consistent with the needs of a small business, the prospective borrower would still have to contend with a potentially cumbersome underwriting process that frequently focuses more upon the creditworthiness and collateral of the business owner than factors associated with the performance of the business.

In addition, small business owners want to focus on running their businesses, not searching for funds. On average, a small business owner may spend 30 hours or more applying for credit from a traditional small business loan program and wait weeks or longer for the underwriting process to run its course and the funds to be disbursed, assuming the loan request is approved.[10] By and large, small business owners do not have the luxury of devoting this kind of time to a search for funds, especially where their own low personal credit scores or absence of sufficient collateral may make the search futile. For small business owners with the fortitude to work through the traditional lending process, the odds of receiving all the capital needed for their business still are not guaranteed.[11]

Online Lenders Role in Expanding Access to Credit to Undeserved Small Businesses

Fortunately for small businesses, new and innovative technology platforms are expanding access to credit and offering attractive alternatives to traditional loans.[12] Online lending platforms, like CAN Capital and other ETA members, provide small businesses with access to smaller loans (typically less than $250,000) and shorter terms[13] that are often better suited to their day to day operating needs or short-term use cases. Online lending platforms also allow small businesses to apply for credit online, from any geographic location, in a fraction of the time it takes to apply for credit from a traditional loan program.[14] Using sophisticated, data-driven algorithms to screen the creditworthiness of potential small business borrowers, our industry is able to reach funding decisions quickly and efficiently, and provide access to capital to approved borrowers expeditiously and in some cases within 24 hours. [15] Taking advantage of these technology platforms has allowed small businesses to focus more of their time and effort on growing their businesses, hiring workers and positively impacting the economy.[16]

Our industry's approach to evaluating risk differs materially from the traditional underwriting process. Instead of focusing on the performance and prospects of potential small business borrowers, traditional loan programs tend to focus on the personal credit histories of the business owners. They require extensive documentation and frequently require specific and/or personal collateral. Their underwriting approach tends to work only for small businesses with an

[10] Small Business Credit Survey, Spring 2014, Federal Reserve Bank of New York ("Small Business Credit Survey"). Of the small businesses surveyed, 40% applied for credit in 2013. Among those that applied for credit, they spent, on average, 33 hours applying, submitting 3 applications to 2.7 financial institutions and more than 51% of them were seeking $100,000 or less.

[11] Small Business Credit Survey at 13. Out of the 40% of small businesses surveyed that applied for credit in 2013, only 39% received all or most of the capital that their businesses required.

[12] In 2014, almost 20 percent of small business applicants sought credit from an online lender. 80 FedReg 42867.

[13] 80 FedReg. 42867.

[14] Joint Small Business Credit Survey at 4,6 (reporting that survey respondents spent an average of 24 hours researching and completing credit applications).

[15] In the case of CAN Capital's platform, business owners can complete a pre-qualification application online or over the phone and receive a no-obligation quote within 10 minutes. The approval rate among businesses that submit a pre-qualification application is approximately 50%. For most customers whose complete applications have been approved, funds are sent the same day as approval or the next day.

[16] A study conducted by the Analysis Group in 2014 estimated that the first $1 billion in loans made by one of the largest online marketplace small business lenders generated $3.42 billion in economic impact through industry, supply chain and job creation gains and that 22,000 jobs were created as a result of small business owners having capital to grow their businesses.[cite]

extensive history of profitability, owners with good personal credit histories, and businesses that do not have an urgent need for capital.

Companies like CAN Capital deploy data-driven algorithms to quickly assess the risk of extending capital to small businesses with the same robustness as traditional lenders. Underwriting decisions are made based on factors including the financial performance and prospects of the small business itself and look beyond the business owner's FICO score (i.e., the criterion on which many banks seem to rely in determining eligibility for a small business loan). Unlike many traditional bank loans, none of the small business financial products we provide require personal collateral (such as a personal residence or automobile); only a pledge of business assets. Accordingly, CAN Capital and other industry peers have built risk and underwriting models based on firmographic variables, including sales and revenue data, cash flow history, and time in business, to approve small businesses whose owners may have personal FICO scores below 650 (arguably the most underserved segment of the small business population). As a result, our platform allows us to safely provide access to capital for many small business applicants that most banks might decline.

While one might think the ease and speed of our industry's underwriting process coupled with our willingness to cater to underserved small businesses would have a negative effect on loan performance, the data tells a different story. Since 2008, for example, CAN Capital's average net write-off rate has been less than 7%. During that time, which includes the most recent financial crisis, we provided small businesses with access to nearly $5 billion in funding. In contrast, small business lending from traditional bank loan programs essentially froze during the same time period, thereby underscoring the resiliency of our business model. [17]

Online Small Business Lending Models

Online lenders are a diverse, nimble and innovative group. The many different models for online lending platforms are the products of the creativity and resourcefulness made possible by the use of financial technology to expand access to credit for small businesses, improve the borrower experience, and bring technology-based efficiencies to the market. As policymakers evaluate the various business models in the online small business lending industry, we hope they appreciate that the broad range and diverse nature of various credit products available to small businesses may not fit neatly into the market segmentation categories used in traditional lending.

Lending models vary based on the nature of the borrower – consumer or business – and the mechanisms used to fund the loans, whether through retail investor participation, private market investor participation, balance sheets, bank partners, and/or hybrid combinations. For example, U.S. peer-to-peer lending – which we would define primarily as the matching of retail investors (although institutional investors may play a large role) with individual borrowers through the SEC registration of a security -- developed within the consumer lending space. To date, this model is predominantly deployed on the consumer side and not for small business/commercial loans.

[17] Access to capital has been critical to small businesses, which were hit harder during the 2008 financial crisis and have been slower to recover. State of Small Business Lending at 3.

Some online lending platforms may finance their loans using a combination of private marketplaces, securitization and balance sheet financing. Balance sheet platforms retain the loans they make (or that are purchased from an original bank) on their own book. These bank partnerships can involve a sharing of the credit risk, or the balance sheet platform may assume the entire credit risk. As a result, the success and incentives of the balance sheet platform are fully aligned with the success of the small business borrower. CAN Capital applies a balance sheet model and we retain all loans that we make or purchase from our bank partners.

Other online lending platforms are "matching" platforms, which enable consumers or small businesses to access a variety of lenders based on their specific needs and that transfer the potential borrower's data to the lenders in an application package. It is important to note that pure "matching" platforms do not lend directly.

It is worth noting that the business models of companies in the industry are also evolving rapidly and in some cases, the business models are converging. For example, pure peer-to-peer platforms may soon begin retaining assets on their balance sheets to diversify their revenue streams (supplementing the origination and servicing fees they currently earn with net interest income) and their sources of financing (e.g., asset-backed warehouse lines of credit).[18]

In short, the business models of some current industry participants already show signs of converging, as do the means by which they finance their businesses (i.e., through private investment, balance sheet financing, bank partners, and securitization) and the loans to which they provide access. The industry will continue to evolve rapidly, as current participants and new ones continue to develop and use data-driven models and technology to reduce acquisition and servicing costs, drive scale, and expand access to capital to small businesses and consumers with new products and services.

In light of this varied and rapidly evolving (possibly converging) industry, we believe it would be premature for policymakers to make sharp distinctions among small business lenders or based on market segments associated with traditional lending. Instead, we suggest that policymakers continue to monitor and study developments in the industry, recognizing the difference between consumer and commercial lenders, and promote further innovation. New technologies and capital products continue to emerge and competition within and between business models is at an early stage. Prematurely regulating the industry based on frameworks designed for traditional lending, as some have suggested, risks stifling innovation and competition and curtailing access to capital for millions of small businesses.

Important Distinction Between Consumer and Small Business Lending

CAN Capital and ETA suggest that as policymakers evaluate the industry, they consider the important and well established distinctions between small business and consumer loan programs and resist calls to regulate these products similarly. Business loans involve risks that are materially different and substantially greater than consumer loans. For example, small businesses have high failure rates and are heterogeneous in nature. Detailed business or financial

[18] 3 is a magic number in the Marketplace Lending Ecosystem, Glenn Goldman, CEO, Credibly, August 17, 2015. https://orchardplatform.com/blog/3-is-a-magic-number-in-the-marketplace-lending-ecosystem/

information is frequently lacking and, even where available, it can be difficult, time-consuming and costly to obtain, verify and interpret. These characteristics make small business lending more risky and unpredictable compared to consumer loan products that are more standardized and generic in nature.[19]

Lending programs for small businesses play a vastly different role in the economy than consumer lending products, which to date have been used primarily for debt consolidation or consumer purchases (e.g. a house or car). Small businesses seek capital for sophisticated use-cases: to hire new employees; to buy new equipment and inventory; to upgrade facilities and expand; and to market themselves. They also seek capital to manage unexpected expenses and slow sales periods.[20] All small businesses utilize funds to generate a return on investment. The businesses use-case is considerably different and more nuanced than generic consumer lending products such as home or automobile loans.

Given these differences, it would be inappropriate and ineffective to regulate consumer and small business lending in a similar fashion. We also strongly believe that doing so could dramatically impact sponsors of small business lending programs and adversely impact small businesses access to much needed capital.

It is important to note that there is extensive legislative history making a distinction between consumer and commercial lending platforms from a regulatory perspective. For instance, the federal Truth in Lending Act (TILA) of 1968 has generally applied solely to extensions of credit made primarily for personal, family, or household use purposes. And although TILA has been amended numerous times since its enactment in 1968, legislators have never amended the law such that it would apply to extensions of commercial credit. As a subset of commercial lending, non-credit card, small business loans have never been subject to TILA's regulatory regime or compliance requirements. To now alter, for the first time, the regulatory landscape to include regulation of small business lending would represent a fairly significant change to the regulatory framework currently adopted by Congress as it relates to the historic distinction between consumer and commercial credit, as exemplified by the distinctions made in the federal financial regulatory laws, such as TILA.

We commend Chairman Neugebauer, Ranking Member Clay and other Members of this Committee for a recent letter that pushed back against mistaken efforts to conflate consumer and small business lending, especially absent careful analysis of how this might impact the flow of capital to small businesses.[21] The letter correctly highlighted how such policy actions would unnecessarily restrict the availability of capital to small business owners, who have already suffered contractions in traditional bank lending since the financial crisis.[22]

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[19] Difference between Business Loan & Consumer Loan, Leigh Anthony, Demand Media, 2016. http://smallbusiness.chron.com/difference-between-business-loan-consumer-loan-3710.html

[20] Small business owners are turning to online lenders for loan products that better fit their financing needs, including small loans to cover unexpected cash flow needs. See Scott Shane, Why Small Businesses are Turning to Online Lenders, Entrepreneur (Apr. 15, 2015); https://www.entrepreneur.com/article/245075

[21] U.S. House of Representatives Financial Services Committee Letter to Treasury Secretary, May 3, 2016. ("HRFC Letter to Treasury") http://www.aba.com/Advocacy/Grassroots/WINNDocs/HFSC-sub-chairs-letter-to-TSY-Lew-on-regulation-of-online-small-business-lenders.pdf

[22] Ibid.

Department of Treasury Recommendations Related to Small Business Lending

In May of this year, the Department of Treasury released a white paper on online lending entitled: "Opportunities and Challenges in Online Marketplace Lending." The paper thoughtfully laid out the significant benefits of online lending platforms to consumers and small businesses. It also made some good recommendations, including potentially facilitating greater interagency coordination to facilitate FinTech innovation, expanding access to credit by creating greater access to government-held data, and promoting access to credit through helping to foster partnerships between online lenders and financial institutions, including Community Development Financial Institutions (CDFIs).

One recommendation in the Department's white paper, however, warrants additional discussion and consideration. The recommendation calls on Congress to consider crafting legislation that would regulate small business loans under $100,000 in a similar manner as consumer loans. The Director of the Consumer Financial Protection Bureau, Richard Cordray, also signaled his preference to regulate lending to small businesses and consumers similarly.[23] If implemented, this hastily drawn recommendation – which runs counter to the wishes of many Members of this Committee[24] – would impact a massive 90% of all small business loans.[25]

For the reasons outlined above, we believe such a policy initiative fails to recognize the important and significant distinctions between consumer and small business lending, would result in stifling innovation and competition, and would significantly roll back the expanded access to credit small business owners enjoy through online lending platforms. The U.S. is home to millions of businesses that require commercial financial products well below $100,000 to sustain and grow their business. The use of funds, commercial or consumer, should dictate the applicable lending regulations, not the dollar amount of the loan.

We also question the evidence the Department used to support this recommendation. For instance, in supporting the $100,000 threshold, the white paper cited a Federal Reserve Bank Small Business Credit Survey (SBCS) to question online small business borrowers' satisfaction with their experience. However, the SBCS survey specifically notes that it's methodology "is not a random sample of small employer firms, and therefore suffers from a greater set of biases than surveys that contact firms randomly," that "caution should be taken when interpreting the results" and that "the data are not a statistical representation of small businesses."[26] We would also highlight that the figure cited by Treasury from the SBCS survey in fact demonstrates that more customers were satisfied with their online experience than those dissatisfied.[27]

Similarly, the Treasury white paper states that "***strong evidence*** indicates that small business loans under $100,000 share common characteristics with consumer loans yet do not

[23] You can see Director Cordray's testimony here; (@1:03:31): https://www.youtube.com/watch?time_continue=3814&v=imfCKtAzLxA

[24] HFSC Letter to Treasury

[25] Office of Advocacy, Small Business Lending in the United States 2013, Victoria Williams, U.S. Small Business Administration, 2014.

[26] The Federal Reserve Banks et. al "The Joint Small Business Credit Survey 2015" at Page 23. https://www.clevelandfed.org/community-development/small-business/about-the-joint-small-business-credit-survey/2015-joint-small-business-credit-survey.aspx

[27] The "score" is not a percentage — instead "the satisfaction score is the share of satisfied with lender minus the share dissatisfied," which yields a differential of 15 (not a percentage).

enjoy the same consumer protections" (emphasis added). [28] However, the paper never cites or specifies the "strong evidence" it used to support its recommendation.

Contrary to the Department's supporting evidence, a recent survey of 592 small businesses conducted by Edelman Intelligence on behalf of ETA found that 99% of online small business borrowers were satisfied with their online lending experience (40% somewhat satisfied; 59% very satisfied). The study found that 91% of online borrowers were likely to take out another loan through an online lending platform.[29]

Relationships With Traditional Lending Institutions and Insured Depository Institutions

Many technology-based online lending platforms are also partnering with traditional banks and institutions, which may fund the loans. Although CAN Capital provides loans and other forms of capital directly to small businesses, it also has a relationship with WebBank, a Utah-chartered industrial bank, member FDIC (the "Bank"), under which CAN Capital provides small businesses with access to certain business loans offered by the Bank. As a service provider to the Bank, CAN Capital assists the Bank to identify potential borrowers, receive and process applications, and arrange for loan closings. The Bank underwrites, originates and funds loans sourced through CAN Capital. CAN Capital is the servicer of small business loans made by the Bank. The Bank may hold the loans or offer to sell them to CAN Capital. If CAN Capital elects to purchase loans from the Bank, it holds them on its balance sheet.[30]

In our experience, bank partnerships of this nature enhance and expand regulatory supervision of online lending platforms and create significant benefits to borrowers and investors. Although non-bank lenders such as CAN Capital are licensed in certain states and subject to supervision and examination by state financial services regulators such as the California Department of Business Oversight, non-banks that partner with a bank become subject to a significant amount of additional regulation and supervision, both by federal banking agencies that oversee the bank and by the bank itself (a complete list of applicable federal and State laws and regulations for online commercial lending is in Appendix B of this testimony). For example, under the Bank Service Company Act, the federal regulator of a bank has the authority to examine a service provider of a bank, such as a non-bank platform that performs services for a bank. In addition, as a matter of their own responsible business practices and to satisfy the expectations of banking regulators with respect to risks associated with third party vendors, banks that partner with online lenders can be expected to operate a robust vendor management program that provides regular and comprehensive oversight of the bank partner's activities on behalf of the bank, including compliance with applicable laws. This oversight frequently includes third party audits by independent consultants that often retain former bank examiners to assist in their review of the non-bank's Compliance Management System and other practices. As a result, online lending platforms that partner with banks voluntarily submit to ongoing regulatory scrutiny at both the federal and state level. Policymakers should understand

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[28] "Opportunities and Challenges in Online Marketplace Lending", U.S. Department of the Treasury, 2016. https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf

[29] See Appendix A.

[30] Such loans may become collateral in the securitization transaction mentioned above.

how these arrangements between online lending platforms and banks ensure compliance with law and safe and sound banking practices and make additional supervision or regulation unnecessary.

Moreover, we note the significant benefits to borrowers and investors derived from partnerships between online lending platrforms and banks. Given the patchwork of lending laws among the states, banks are able to offer loan products on a more uniform basis than non-bank lenders, enabling the provision of credit to a broader spectrum of qualified small business borrowers of varying degrees of credit quality in all states. Banks that partner with non-bank platforms are able to provide credit to otherwise underserved borrowers and increase competition for loans to small businesses generally, which as noted above, is vitally important to support business lending. Borrowers also benefit from the fact that their lender is subject to comprehensive regulation and supervision by a federal banking agency as well as the bank's chartering agency, which may be a state or federal banking agency. Investors who purchase loans originated by banks through a partnership with a non-bank platform likewise benefit from the enhanced regulatory scrutiny applied to the origination of the loans they purchase. Although the recent *Madden v. Midland* Funding case has introduced some uncertainty to the secondary market given the case's errant analysis of federal preemption and failure to apply the longstanding common law "valid when made" doctrine, we believe that thoughtful investors recognize the enhanced value of loans that are originated through a collaboration of a bank and an innovative non-bank platform such as CAN Capital given the focus that both the bank and the non-bank platform place on satisfying regulatory requirements for safe and sound banking practices, including prudent underwriting, as well as compliance with applicable laws.

Federal Policymakers Should Facilitate Positive Innovation in Lending

ETA and CAN Capital encourage federal policymakers to facilitate positive innovation in lending, and proposes the following options for achieving this goal:

- Federal policymakers should encourage online lending platforms to participate in federal programs, such as the loan guarantee programs of the Small Business Administration,

- The government should encourage traditional lending institutions to refer small business customers whose loan applications they have declined to online small business lending platforms. To this point, policymakers should consider the potential benefits in encouraging banks to participate in and help grow online lending to small businesses. Due to their underwriting requirements and higher overhead expenses, it is often not profitable for traditional lending institutions to extend small amount, short term loans to small businesses. Rather than turn customers seeking loans that do not meet their underwriting criteria away altogether, traditional banks could refer them to online lenders. Where the small business customer is able to secure a loan based on such a referral or joint-origination effort, the bank is able to maintain a good relationship with the customer as well as promote access to necessary capital from an alternative source.

- Federal policymakers should encourage industry self-regulatory efforts and determine whether, in light of such efforts, any increased government regulation of online small business lending is necessary. Groups like ETA, the Innovative Lending Platform Association, and the Marketplace Lending Association are working to develop industry standards for loan disclosures and borrower rights which, if supported by industry participants and government actors, may obviate the need for additional regulations.

- Federal policymakers should support initiatives that create a harmonized and rationalized policy framework that foster competition. For example, state law harmonization efforts or the creation of a federal licensing regime could permit more uniform application of policy and potentially provide customers with a single point of contact. This approach could prevent application of an inefficient and duplicative patchwork of state and federal laws that increasingly drive friction in a modern, internet-based economy, and fail to accomplish regulatory objectives.

Conclusion

CAN Capital thanks the Subcommittee for the opportunity to provide its input on expanding access to capital through online small business lending and alternative finance platforms.

For various reasons stated above, traditional small business loan programs are not able to adequately serve the capital needs of our nation's small businesses. This is especially true when small businesses need $100,000 or less, which accounts for 90% of small business loans.[31] Companies like CAN Capital and other ETA member companies have been able to address this unmet need by developing data-driven risk and underwriting models and user-friendly technology platforms to quickly and effectively provide small businesses with access to the capital they need to grow their businesses and, in turn, help propel the U.S. economy. Since 1998, CAN Capital has provided historically underserved small businesses with access to over $6 billion in the form of innovative financial products that address their needs for smaller amounts of capital with flexible payment options.

Policymakers should recognize the existing framework of federal and state laws that apply to online small business lending and be sensitive to the risk that additional regulation of non-bank platforms will stifle innovation and competition and rollback the expanded access to capital that small businesses enjoy through platforms like CAN Capital. Accordingly, we suggest that policymakers continue to monitor and learn about the industry and promote further innovation as well as increasing collaboration between traditional bank lenders and non-bank platforms like CAN Capital that can help all participants better address the capital needs of their small business customers.

[31] Office of Advocacy, Small Business Lending in the United States 2013, Victoria Williams, U.S. Small Business Administration, 2014.

Appendix A


Online Lending Drives
Main Street Small Business
Growth & Satisfaction
ETA
96%
Of Online Borrowers say the loan they secured enabled or drove business growth
91%
Of Online Borrowers are likely to take out another loan from an online lending company
Top 3 Reasons for Choosing Online Lenders
63%
Speed of Funding
57%
Easy Application Process
51%
Affordable Total Loan Cost
Minimizing Total Cost
The majority of Small Business Organizations (SBOs) look to minimize total loan cost when facing a short-term ROI opportunity
$
%
57%
Chose a 6-mo higher-APR loan over a 9-mo lower-APR loan in order to minimize total fees & expenses
*Note that APR does not equal the total dollar cost of loan
Online lending can save time, which is money
$170
Average value SBOs estimate 1 hour of their time is worth
Small business survey respondents have previously reported that they spent an average of 24 hours researching and completing credit applications with traditional lenders. Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia, Joint Small Business Credit Survey Report, 2014 (released February 2015).
SBOs anticipate 5x return for every $1 borrowed
Most Common Reasons for Seeking Business Loans
54%
Equipment Purchase
51%
Inventory Purchase
99% Overall Satisfaction
40%
Somewhat Satisfied
59%
Very Satisfied
Lending Options
Number of SBOs that believe they have more options compared to 5 years ago
less options
18%
don't know
15%
67%
more options
94%
Of those who believe they have more lending options perceive it is a positive thing
Business Loans
3
Average number of loans a SBO has taken out in past 5 years
$25k
Average size of loan sought
Education
89%
Of respondents have at least some college education
Survey Criteria
Data based on 592 SBOs surveyed by Edelman Intelligence March 23 – 25.
18+ Years Old
Owns a small business
Have been in business for at least 1 year
Are part of financial decision-making process
Annual busines revenue of $50k-$5m

Appendix B
The Electronic Transactions Association
Federal and State Laws and Regulations for Online Commercial Lending

Online small business lending platforms are transforming the small business lending market by making it more cost efficient and convenient for small businesses to access the capital they need to acquire equipment, hire employees, and grow. These online small business lending platforms use advanced analytics and technology platforms to lend to small businesses.

Although online small business lending has received considerable attention in recent years as a beneficial and "new" technology, the business model, at a basic level, involves many of the same steps as traditional commercial lending – the marketing, underwriting, closing, servicing, securitization (in some cases), and collection of loans.

In this regard, contrary to frequent references to the "Wild West," commercial online lending is subject to various federal and state laws and regulations. Depending on circumstances, such as the nature of the product, the lending model, and the states in which the loans are offered, these laws may include requirements related to fair lending, licensing, interest rates, credit reporting, and debt collection, among other requirements.[32]

For more information, please contact Scott Talbott, Senior Vice President, Government Relations, the Electronic Transactions Association at stalbott@electran.org.

The following chart outlines federal and state laws relevant to commercial online small business lending.

Law[33]	Summary
Section 5 of the Federal Trade Commission Act	Prohibits unfair or deceptive business acts or practices (UDAP).
Equal Credit Opportunity Act (Regulation B)	Prohibits creditors from discriminating against applicants on basis of race, color, religion, national origin, sex or marital status, or age, or the fact that all or part of the applicant's income derives from any public assistance program or the fact that the applicant has in good faith exercised any right under the federal Consumer Credit Protection Act or any applicable state law. Requires creditors to provide notice of the reasons for any adverse action taken on a credit application or existing credit account.

[32] Many lending platforms partner with banks and other regulated entities which fund loans. As a result, online small business lenders are often obligated to comply with the commercial lending regulatory requirements and policies and procedures of such banks.

[33] Application of these laws may vary depending on circumstances, such as the nature of the product, the lending model, and the states in which the loans are offered.

Law[33]	Summary
Fair Credit Reporting Act (Regulation V)	Requires a permissible purpose to obtain a consumer credit report, and requires persons to report information to credit bureaus accurately; imposes disclosure requirements on creditors who take adverse action on credit applications based on information contained in credit reports; requires creditors to develop and implement an identity theft prevention program.
Bank Secrecy Act as amended by the Patriot Act	Requires covered financial institutions to implement anti-money-laundering procedures and customer verification programs.
Economic Sanctions	Requires compliance with economic and trade sanctions against targeted countries, entities, and individuals.
Electronic Signatures in Global and National Commerce Act	Authorizes legally valid and enforceable agreements utilizing electronic records and signatures and requires businesses that want to use electronic records or signatures in consumer transactions to obtain the consumer's affirmative consent to receive information electronically.
Investment Advisers Act of 1940	Requires investment advisers to meet recordkeeping, custodial, reporting, and other regulatory responsibilities.
Securities Act of 1933 (Public Offerings and Private Offerings)	Public Offerings: Online lenders engaged in the public offering of securities are required to register the securities offerings with the Securities and Exchange Commission, unless the securities or offerings are exempt from the registration requirements of the Securities Act of 1933. Private Offerings: Online lenders may engage in private offerings of their securities, including offerings made in reliance on the safe harbors in Regulation D.
Securities Exchange Act of 1934 Risk Retention Rule	Securitizers or sponsors of asset-backed securitizations (ABS), including securitizers that are depository institutions, are generally required to retain an economic interest equal to at least 5 percent of the credit risk of the assets collateralizing the ABS issuance.
State Lending Laws	Some states have licensing requirements applicable to brokers, lenders, servicers, collectors and investors of commercial loans and leases, including equipment leases and loans, mezzanine loans, mortgage loans, and unsecured loans.

Law[33]	Summary
State UDAP Laws	Most states have “mini-FTC acts” that prohibit unfair or deceptive business acts or practices.
State Usury Laws	Govern the amount of interest that can be charged on a loan.
State Debt Collection Laws	Some states have debt collection laws applicable to commercial finance transactions.
Uniform Commercial Code	Comprehensive set of laws governing commercial transactions.