

FINTECH AND TRANSPARENCY IN SMALL BUSINESS LENDING

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WEDNESDAY, JULY 13, 2022

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON OVERSIGHT,
INVESTIGATIONS, AND REGULATIONS,
Washington, DC.

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

Present: Representatives Velázquez, Phillips, Newman, Bourdeaux, Chu, Craig, Meuser, Van Duyne, Donalds, and Fitzgerald.

Chairman PHILLIPS. All right. Good morning, everybody. I am going to call the meeting to order. And without objection, the Chair is authorized to declare a recess at any time.

I want to begin by noting some important requirements. Standing House and Committee rules will continue to apply during hybrid proceedings. All Members are reminded that they are expected to adhere to these rules, including decorum. House regulations require Members to be visible through a video connection throughout the proceeding. So please keep your cameras on. Also, please remember to remain muted until you are recognized to minimize background noise.

In the event a Member encounters technical issues that prevent him or her from being recognized for their questioning, I will move to the next available Member of the same party, and I will recognize that Member at the next appropriate time slot provided that they have returned to the proceeding. And with that, I will begin with my opening statement.

Increasing the flow of capital to American small businesses is one of this Committee's foundational goals. When entrepreneurs can secure financing on reasonable terms, they create jobs, expand their businesses, and move the economy forward. Unfortunately, most American business owners feel that they cannot adequately access capital. According to a 2022 Federal Reserve Survey, 59 percent of small employer firms said they have unmet financing needs. So we must find ways to fill that gap and deliver more funding to small firms on safe and responsible terms.

Massive developments in financial technology, commonly known as fintech, have shown real promise for expanding access to credit for small firms. Over the years, entrepreneurs have flocked to fintechs for their capital needs. One study found that by 2016, non-

bank lenders had a market share of close to 60 percent in the small business lending sector. During the PPP, Paycheck Protection Program, we witnessed the ability of fintechs to make small-dollar PPP loans to small businesses, particularly those in underserved communities, more effectively than traditional banks could.

Small businesses often turn to fintechs for their speedy approval process, more diverse financing options, and alternative metrics for credit worthiness. However, while fintech lending has helped many entrepreneurs, concerns are growing that industry practices may harm and even target small businesses.

For instance, the speed at which fintech lenders deploy capital can come at a very substantial cost. A conventional bank loan typically carries an APR of 4 to 13 percent. For fintechs, APRs for online loans and other financing products can start at 7 percent, and can climb higher than 100 percent. These terms are not always clear to small businesses. As many online lenders provide little or no information upfront to prospective borrowers about the loan or the product and often use metrics other than APR to disclose the cost of capital.

Some online lenders also engage in predatory practices that put small businesses particularly at risk. For example, merchant cash advances, MCAs, allow a lender to receive a fixed percentage of future sales until the financing is repaid. The extremely high interest rates and daily repayments associated with MCAs can cause businesses to enter into an out-of-control debt spiral.

Furthermore, many MCA lenders require that borrowers sign an obscure legal instrument known as a confession of judgment to get the money. By signing that, borrowers waive their legal rights regarding any legal dispute that might arise. And when a court enforces the confession of judgment, it locks a small firm into that unsustainable debt cycle and ultimately forces the business to close.

Small Business advocates also worry about the lack of transparency around fintech underwriting. The data and algorithms that control automatic underwriting can pull unrelated information, like who an applicant follows on social media, or the number of criminal records in an applicant's ZIP Code. These underwriting practices lack transparency and have the potential to unfairly deny credit to protected groups or make those products more expensive for all.

As the fintech sector evolves, Congress must keep and ensure industry practices are not unfairly taking advantage of the entrepreneurs, especially those who may be vulnerable to abusive practices.

So today, I look forward to discussing the benefits and risks of fintech lending for small businesses, and what this committee can do to both protect and expand opportunities for entrepreneurs. With that, I would like to yield to the Ranking Member, Ms. Van Duyne, for her opening statement.

Ms. VAN DUYNE. Thank you very much, Mr. Chairman. A little over an hour ago, the latest CPI numbers peaked at a whopping year over year increase of 9.1 percent. Maybe more shocking is that inflation rose 1.3 percent from just a month ago. This month's surging inflation is just the latest in a long line of pain inflicting eco-

conomic numbers that have come under President Biden's leadership. At this point, one thing is clear: Small businesses in our communities cannot prosper, let alone survive if this administration's current policies and frivolous spending continue.

Over a year ago, Congress forced through their \$1.9 trillion reconciliation package. Americans now feel the full inflationary effects that Republicans were warning of. Filling up at the gas station is now a shocking experience. Grocery store visits cost over 12 percent more, and housing prices are almost untenable. There is no doubt we are now paying for this administration's free-money policies.

And, unfortunately, it seems that we have reached the point of *deja vu*. As labor shortages and supply-chain troubles persist, we are back to the talks of another \$1 trillion reconciliation package. If that wasn't bad enough, Democrats plan to include tax increases on small businesses in this proposed bill.

While details are still developing, I want to say loud and clear, that any changes or expansions of the net investment income tax will be a tax on small businesses' pass-through entities.

When I visit the small businesses that make North Texas one of the quickest growing areas in the United States, they tell me the same thing: The government needs to stay out of the way. As we are all well aware, small business owners are some of the best America has on offer. And yet, they struggle to be optimistic when it seems they are working against a tough economy and a government that just won't listen.

According to a survey by NFIB, the number of small business owners expecting business conditions to improve has continued to go down, decreasing every month this year. Every American knows this is a difficult moment, but luckily, we can turn the tide back in favor of economic growth. We can put small businesses back in the driver's seat by ending the trillions of dollars in reckless spending and aggressively reforming regulations.

In addition to these challenges, access to capital remains an important issue for American small businesses, and as it could be the difference between business expansion or business stagnation.

As today's hearing title suggests, Small Business Lending, must include an examination of just how small business fairness over the last 2 years during the COVID-19 pandemic, and how fintech lenders performed during the Paycheck Protection Program. And anything less would shortchange this topic.

Given at this Oversight Committee hearing, I would be remiss not to mention my disappointment that we have yet to hear from Secretary Yellen regarding her legal and statutory requirement to testify.

Across the board, these are important issues and topics that deserve the attention of this Subcommittee and Members of Congress. And I look forward to today's conversation. I would like to thank all of the witnesses that are here today. And thank you, Mr. Chairman, I yield back.

Chairman PHILLIPS. Thank you, Ms. Van Duyne. The gentlelady yields back. And with that, I would like to introduce our witnesses today. Our first witness is Mr. Sean Salas, Chief Executive Officer and Co-Founder of Camino Financial, a digitally native Community Development Financial Institution, known as CDFIs,

with a variety of small business loan offerings for firms of all sizes, including solopreneurs, a signatory of the Small Business Borrowers Bill of Rights, Camino is an example of how to lend to small businesses online in a fair and transparent manner. We welcome you, Mr. Salas.

Our second witness is Ms. Joyce Klein, Senior Director of the Business Ownership Initiative at the Aspen Institute. A central focus of her work over 20 years includes examining the role of business ownership and micro finance in addressing the challenges of racial inequity and the racial wealth gap. She was also instrumental in helping start the Responsible Business Lending Coalition which advocates for responsible practices and transparency in the small business lending sector. We welcome, you, Ms. Klein, and look forward to your testimony.

Our third witness is Ms. Diane Paterson, the Regional Director Of the Twin Cities Small Business Development Center, SBDC, at the University of St. Thomas in Minneapolis, Minnesota. In her capacity, she counsels small business owners on locating funding sources for working capital and expansion and is certified as an economic development finance professional and revolving loan fund expert by the National Development Council. She is also a former business owner herself, and brings a valuable multifaceted perspective to our discussion of these important issues. We welcome, you, Ms. Paterson, and thank you for joining us today.

I would now like to yield to the Ranking Member, Ms. Van Duyne, to introduce our final witness.

Ms. VAN DUYNE. Thank you, Mr. Chairman. Our next witness is John Griffin. Dr. Griffin is the James A. Elkins Centennial Chair in Finance at the McCombs School of Business at the University of Texas in Austin, with a focus on banking, international finance, and structured finance. Dr. Griffin has been a professor at Arizona State University, Yale University, Hong Kong University of Science and Technology, and Harvard Business School. In addition to teaching, Dr. Griffin has conducted extensive research in published findings on numerous banking topics, including the 2008, 2009 financial crisis. His and his team's most recent research examines the intersection of fintech lending within the Paycheck Protection Program also known as PPP.

Dr. Griffin, thank you for joining us today. I look forward to your testimony. I would also like to thank all the witnesses for joining us. And, Mr. Chairman, I yield back.

STATEMENTS OF SEAN SALAS, CHIEF EXECUTIVE OFFICER AND CO-FOUNDER, CAMINO FINANCIAL; JOYCE KLEIN, SENIOR DIRECTOR, BUSINESS OWNERSHIP INITIATIVE, ASPEN INSTITUTE; DIANE PATERSON, REGIONAL DIRECTOR, TWIN CITIES SMALL BUSINESS DEVELOPMENT CENTER; AND JOHN GRIFFIN, JAMES A. ELKINS CENTENNIAL CHAIR IN FINANCE, MCCOMBS SCHOOL OF BUSINESS, THE UNIVERSITY OF TEXAS.

STATEMENT OF SEAN SALAS

Chairman PHILLIPS. Thank you, Ms. Van Duyne. And now to you, Mr. Salas, you are recognized for a 5-minute opening statement.

Mr. SALAS. Thank you, Chairman Phillips and Ranking Member Van Duyne, and other Members of the Subcommittee. I really appreciate it, and I am honored to be here today. My name is Sean Salas, and I am the co-founder and CEO of Camino Financial.

Camino Financial is a fintech lending platform that empowers entrepreneurs to grow their business and boost access to capital for underserved communities. Our microloans provide small business owners with the flexible financing they need to thrive in a competitive market.

We are a national Community Development Financial Institution, or CDFI, that is pioneering affordable credit through technology and AI. Our mission is simple: To build generational wealth in underserved communities. We take a digital first approach, and applications are 100 percent online. We predominantly serve entrepreneurs in California, but our digital first approach allows us to serve businesses in other states.

Today, I am proud to say that we are one of the largest Latino-focused small business lenders in the U.S. Over the last 6 years, we have helped over 9,500 small businesses, deploying over 200, almost \$200 million in capital. We have also created one of the largest bilingual content hubs that offers entrepreneurs over 1,200 bilingual articles related to business and entrepreneurship that reaches hundreds of thousands of website visitors per month. We provide a camino, or a pathway to capital by educating our borrowers. This pathway involves providing resources that teach them how to formalize their business and access the tools they need to get on a path to qualify for larger, lower interest rate loans.

I founded Camino Financial with my brother, Kenny, while completing our MBAs at Harvard Business School. We are the proud sons of a Mexican entrepreneur who truly sought the American Dream. Our mother opened over 30 restaurants in Southern California while raising six children. Imagine that. Unfortunately, when I was 12 years old, her entire business collapsed. She moved us to Mexico to restart our lives despite us being U.S. citizens.

The moment Kenny and I graduated from high school in Mexico, we decided to immigrate back to the U.S. to pursue what my mom had lost, the American Dream. We were lucky enough to be admitted to UC Berkeley, and after, build our careers in finance. While working in finance, we realized the capital gap of investing in micro businesses in minority communities. So we decided to leverage our MBA experience to incubate Camino Financial to help busi-

nesses like my mother's grow to a point where they can access a broader suite of wealth-building solutions.

Now for context, the average Latino business earns around \$250,000 in revenue per year. That is about half of the national average. Most Latino-owned businesses are micro businesses, not even small businesses, with four or less employees. Banks and larger institutions—and larger institutional investors do not actively service this lower end of the market, comprising over 97 percent of Latino businesses with the unmet credit demand north of \$20 billion.

I would like to share a few examples of entrepreneurs we help. Letesha, a business owner and restaurant owner, needed a business loan during a busy season to hire and train more staff. She never received a business loan and needed guidance. After submitting her application, a Camino Financial business loan specialist called her within minutes to walk her through the process so that she can train and hire more staff.

Prior to working with us, Baldemar, who owns a car repair and maintenance shop, used personal loans for his business. After realizing that personal loans were not sufficient for his business, he worked for Camino Financial to buy him into and increase his company's efficiencies and profits.

People like Letesha and Baldemar reach out to Camino Financial because of our easy digital application, because we are a digital-first company, and a lot of our business is done online. How that is said, transparency is critical to our success. That is why we joined the responsible business lending coalition. That is also why we support the efforts of Chairwoman Nydia Velázquez to create protections for small business owners. We believe that borrowers should have access to responsible loans and information that allows them to uniformly compare and select the financing that makes sense for them.

I should also note that in California, we are already required to disclose much of our information to help protect borrowers. And while I am not here to discuss our competitors, I will say that California interest and fee disclosures are not hindering our business, they are leveling the playing field. In the end, our business is about helping entrepreneurs achieve the American Dream. It is my hope that we can continue to grow while helping many more budding entrepreneurs live that American Dream. Thank you for your time and the privilege to speak today.

Chairman PHILLIPS. Thank you, Mr. Salas. And with that, I welcome you, Ms. Klein. You are recognized for 5 minutes for your opening statement.

STATEMENT OF JOYCE KLEIN

Ms. KLEIN. Thank you. Chairman Phillips, Ranking Member Van Dyne, and Members of the Committee, thank you for inviting me to appear before the Oversight Investigation and Regulation Subcommittee today to speak with you about the importance of transparency and the role of financial technology in small business lending. My name is Joyce Klein, and I am the senior director of the Aspen Institute's Business Ownership Initiative.

At the Business Ownership Initiative, we work to understand the needs of and the barriers facing the most underserved small businesses, and to develop solutions for reaching them. We have been doing this work at the Aspen Institute for 30 years, and over that time, we see many changes in the financial services landscape. But one constant is that entrepreneurs still face challenges in accessing capital, and this is particularly true for certain types of entrepreneurs. It is true for women, for people of color, for immigrants, for those in rural communities.

I also serve as the Chair of the Responsible Business Lending Coalition which is a network of nonprofit and for-profit lenders, like Sean in Camino, investors and small business advocates. And we share a commitment to innovation of small business lending, but also concerns about the rise of irresponsible small business lending practices. And so my remarks today draw from both our work at the Aspen Institute, and from the work of the Responsible Business Lending Coalition.

So when considering the implications of fintech for small business lending, it is important to focus on financial technology in its broadest sense, which involves the application of digital technologies to financial transactions. And, today, virtually every small business lender, whether they are a bank or a credit union or a CDFI or a fintech firm or some other type of commercial finance company is using financial technology. And there are many ways in which financial technology can help expand access to capital to those who have been excluded from or marginalized in our capital markets.

But through our work, we have learned that if the goal is to expand access to responsible capital, it is not the type of institution that is providing the financing or whether and how they use technology that is most important. What is most important is getting the financing products right and the financial practices right.

So with regard to products, we have seen progress in increasing lending to underserved businesses is when lenders offer smaller loans, and they underwrite by focusing on cash flow and a flexible approach to credit histories, rather than by focusing on collateral, equity, and credit scores. And the right practices are also essential in reaching segments of the small business market that haven't been reached by banks. And this is where CDFIs are particularly adept, and it is where fintech can bring technology that is accessible and user-friendly. But we have to balance greater access with borrower protections.

The economics of smaller-dollar small business lending are really challenging, and that creates pressure to sometimes use practices that can be abstractive or even predatory.

And so this brings me back to our work at the RBLC where we have created the Small Business Borrowers Bill of Rights. BBOR puts the small business at the center of the financing transaction, identifying six rights we believe should be upheld. And the first among these is the right to transparent pricing and terms.

The RBLC has been a part of diverse coalitions that have been successful in passing small business truth-in-lending legislation in California and in New York. And the RBLC is grateful for the work that Chairwoman Nydia Velázquez has done to promote trans-

parency and responsible practices in small business financing, including her leadership in introducing H.R. 6054, the Small Business Lending Disclosure Act of 2021, which would require lenders to disclose information that enables small businesses to make informed choices.

The original Truth-in-Lending Act was not applied to commercial financing because it was assumed that businesses had financial expertise that consumers did not. And while that is true for some businesses, it is not true for most. So most small businesses in the U.S. are sole proprietors; they are not corporations; and they are home daycare centers and cleaning and landscape businesses and food trucks and small retail shops, hair and nail salons. They do their own books and finances. They may, but they may not even have access to a part-time bookkeeper or accountant to help them.

And with the emergence of new small business lending, financing products has come at greater variation in how those products are structured in place. And so, we believe it is vital that when small business owners seek financing, they have the information to fully understand the cost and the terms of each offer to compare across those products, and make the best choice for their business. And essential to that is the disclosure of APR, Annual Percentage Rate, which is the only metric that allows borrowers to make apples-to-apples comparisons across products.

And I would note that lack of transparency actually inhibits competition. Market competition relies on price disclosure. Without transparent disclosure on pricing that allows borrowers to compare costs, financing companies don't have an incentive to innovate and compete on price. So as a result, financing—

Chairman PHILLIPS. Ms. Klein, your 5 minutes has expired. So if you could wrap it up.

Ms. KLEIN. Thank you so much for the ability to testify today, and I look forward to answering your questions. Thank you.

Chairman PHILLIPS. Thank you. Thank you very much. And now I recognize my fellow Minnesotan, Ms. Paterson, for 5 minutes for your opening statement.

STATEMENT OF DIANE PATERSON

Ms. PATERSON. Good morning, and thank you, Chairman Phillips, and Ranking Member Van Duyne. My name is Diane Paterson, and I am the regional director of the Small Business Development Center in the Twin Cities in Minnesota. We have been an SBDC for over 31 years. The SBDC program is a national program that is a matching partnership program with the SBA and organizations of higher ed.

We work with all kinds of businesses, small to medium generally, startup to exit planning. So we have seen a lot of businesses. We worked with a lot of businesses during the recession, and we certainly had a great deal of businesses coming to us during the pandemic.

With today's online credit-lending environment where many fintech services offer a 4-minute application and 24-hour turnaround to access funds, the SBDC has seen small business owners navigating confusing fine print, adverse interest rates, thwart loan terms, and prepayment penalties. These lending practices are espe-

cially harmful to small, young, less profitable, and minority-owned businesses, who already struggle to access financing because they lack the business history or collateral that traditional banks require. Yes, the ease and speed with which small business borrowers can access fintech credit is appealing. These businesses tend to use this loan option in conjunction with other forms of credit, making them financially vulnerable.

The application process for a traditional lender takes days. The approval process itself can take weeks or longer depending on the meeting schedule of the loan committee. Standing in stark contrast, two fintech options, biz to credit, and blue line advertise 4- and 5-minute completion times respectively. Both promise next-day availability of funds.

While fintech loans address pain points in the loan application process, these loans subject the borrowers to much higher interest rates and other terms that cause many to default. The biggest issue in fintech lending practices is the lack of transparency in the price of their products. As consumers, we are accustomed to seeing rates of 5-1/2 to 6-1/2 APR. This commonly understood Annual Percentage Rate terminology is familiar. It makes sense. Fintech borrowers read rates ranging from 3-1/2 to 4-1/2 percent and assume their APR. What they do not realize is the fintech rates are regularly calculated on a daily basis. That results in a lending relationship that subjects the borrower to an interest rate in the range of 58 to 63 percent. Simply put, fintech lending practices are an issue with this daily calculation, the first of several fine-print problems.

OnDeck interest rates are posted at 3-1/2 to 5 percent, but in reality, they range from 24.6 to 58.6 percent. Kabbage, on the other hand, advertises a loan fee instead of an interest rate. Lending Club charges 9.77 percent to 35.71 percent interest, but then assigns an additional loan origination fee ranging from 1.99 percent to 8.99 percent.

The cost of fintech credit is high. The terminology is confusing. Adding more fuel to the fire is the repayment terms, which are traditionally very short. Fintech loan terms typically are 6 to 12 months. This greatly impacts the level of the borrower's monthly debt service. While many fintech lenders offer weekly installments, that doesn't change the reality that these payments are often too large for a small business' cash flow to digest.

To illustrate, a client of the Small Business Development Center founded a craft brewery operation making a gluten-free beer. Due to the nature of their product, we were unable to brew beer using other craft brewer's equipment during the start-up phase. As such, they financed new machinery using a \$375,000 loan from a bank. The taproom was an instant revenue generator. But the revenue from distribution lagged behind their projections. They approached their bank for a second loan for \$100,000 working capital to bridge in the distribution side of the business caught up—

Chairman PHILLIPS. Ms. Paterson, your time is up. If you could wrap it up, we would appreciate that.

Ms. PATERSON. Yes. So thank you very much. The debt service for that business was \$11,208 a month. That is still too high. But thank you, and I look forward to your questions.

Chairman PHILLIPS. Thank you, Ms. Paterson. And you I recognize Dr. Griffin for 5 minutes for your opening statement.

STATEMENT OF JOHN GRIFFIN

Mr. GRIFFIN. Chairman Phillips, Ranking Member Van Duyne, and Members of the Committee, thank you for inviting me to appear before the Small Business Subcommittee to speak to you about fintech lending. I am John Griffin, a forensic finance professor at the University of Texas, and also a founder of Integra FEC, a small consulting business which investigates financial fraud.

This testimony is based on my academic paper with co-authors Professor Sam Kruger and Prateek Mahajan, entitled, "Did fintech Lenders Facilitate PPP Fraud?" It is found with links from my website and SSRN.

I will briefly summarize some of the main findings of our paper, and then discuss the potential policy implications. Our paper analyzes the SBA's Paycheck Protection Program, called PPP, based on four main metrics of potential misreporting, which are cross-verified with and against each other, and with seven additional indicators. The main findings of the paper are first: Misreporting indicators consistently concentrate in fintech lenders. Overall, fintechs are 6.5 times more likely to process misreported loans.

Second, misreporting is not a simple function of disbursing funds quickly in early 2020. To the contrary, misreporting steadily increased throughout the program. At the end of the PPP program, in May of 2021, the level of suspicious lending through fintechs are four times the level at the start of the program.

Third, the four main measures place the magnitude of likely fraud at \$64 billion, but our additional indicators and analysis point to \$117 billion. Since these analyses use only public data and take a conservative approach, the total amounts are likely even larger.

Finally, we find that suspicious loans are being overwhelmingly forgiven by the SBA at similar rates to other loans. An extremely few are prosecuted. A key result can be seen in Figure 2 from our paper which is reproduced also in my report. The red and light yellow are fintech lenders, and the lenders in gray are traditional banks. The top 12 lenders with the most misreporting are all fintech and are all shown at the left of the graph.

Though there are also some problems at traditional banks, most traditional banks are to the middle and to the right of the graph with consistently lower levels of misreporting. Interestingly, however, not all fintech lenders have high rates of misreporting.

Our findings have important policy implications. First, the PPP program did not include robust verification requirements. This led to substantial cost to taxpayers, particularly in 2021, when there was less concerns to distribute refunds quickly.

Second, fintech lending, no praise for getting funds out quickly, needs substantial improvement in due diligence practices. Two fintech lenders with an established track record persistently have low rates of misreporting, indicating that online lending itself need not be substandard.

Third, three leading academic papers cited in my report showed that the PPP saved relatively few jobs at an extremely high cost per job. Along with our evidence, this indicates that the PPP program was an ineffective use of taxpayer dollars and should cause the lender to reconsider the efficacy of future SBA lending programs.

Fourth, incentives of some of the PPP appear misaligned in the fintech lenders with few employees relatively little track record and lax due diligence procedures made billions of dollars disbursing fraudulent loans. In my opinion, the fintech organizations and individuals who facilitated such activities should not be allowed to engage in future government programs.

Fifth, with the increasing scale of fraud through time indicates that the fraudsters targeted the program, and current penalty and enforcement systems are not effective. If a system is not changed for future SBA lending programs, the most likely outcome is even more of the same. Government agencies can assist in transparency by making more detailed data widely available.

Finally, though we should try to design better systems for the future, fraudsters typically find new holes in the system. This is why I believe that serving justice for financial crime is not simply old-fashioned, backward-looking as some might think, but rather, forward-looking as well. Our analysis shows that less than 1 in 10,000 loans with a misreporting indicator has been prosecuted. Without prosecuting the organizations and networks of individuals who stole billions of dollars from U.S. taxpayers, these same individuals will most likely amount even more cost for society going forward. Additionally, justice serves the warning to others and deters future crime.

Much more can and must be done. Other important details can be found in our academic paper online. Thank you for your attention to these important issues. I look forward to further questions.

Chairman PHILLIPS. Thank you, Dr. Griffin. And thanks to all of our witnesses. We appreciate everything that you have shared with us. I will now begin by recognizing myself for 5 minutes.

My first question is to you, Ms. Paterson. We all know the SBA has not yet allowed fintechs to participate in programs other than PPP, but they have clearly shown potential in expanding access to capital for small businesses. However, their involvement in the wider small business lending sector and in PPP specifically have also raised serious fraud and transparency-related concerns as we have heard in testimony. You detail in your testimony that guidelines to set uniformity in fintech lending practices specific to the cost of capital would be worthy solutions to this issue.

So my question is, what should the SBA and this Committee specifically focus on as it deliberates on the potential involvement of fintech, specifically, in SBA lending programs, particularly given that in SBA lending programs, the agency often sets the underwriting terms?

Ms. PATERSON. Primarily, and all the witnesses mentioned this, is the transparency piece, as well as a recording piece. We really don't have good data regarding the default rate of fintech loans. We surmise that it is much higher than traditional lending, but we really don't have that data. But from a borrower's stand-

point, the transparency is key. When you tell a client that their interest rate is 58.6, and they thought it was 4.5, that is a—that is really hard for that business to digest. The other thing that we are seeing is once we—the borrower understands the terms that they have signed on to are the prepayment penalties, which can be as high as 20 percent. And so, when they recognize that they are paying 60 percent interest rate, and they want to refinance that loan, they have difficulty doing so because you have principal plus the prepayment penalty. And so we don't see them refinanced. I have only seen one, and that was actually that craft brewery, because the bank was nervous that they would not get their original 375 back. So I just think from a regulatory standpoint, I love the accessibility of fintech loans, but we need that transparency so that borrowers truly understand the loan documents that they are signing, the interest rate, and what that impacts if the term is only 6 months to a year.

Chairman PHILLIPS. All right. Thank you, Ms. Paterson. So now, Mr. Salas, I will turn to you on the same subject. Like many of us believe that online lenders should adopt the same disclosure and transparency policies of traditional banks. And some of them, some fintechs have already adopted those. But can you detail for all of us some of the policies that you have adopted and the importance of those policies relative to this issue?

Mr. SALAS. Absolutely. So as I mentioned earlier, we are already regulated under truth-in-lending-like laws in California where we disclose to our Members in a clear and simple manner terms. And one of the most critical, what I would say metrics in pushing transparency and creating a level playing field, is APR. We believe that APR is comparable across different credit products. That every lender needs to use their best commercial efforts to disclose that APR at their earliest convenience. And we have not been hindered at all from the business perspective in that disclosure. And we have found that by having that requirement under law, it creates for more fair and competitive marketplace which ultimately benefits the borrower.

Chairman PHILLIPS. I appreciate it. Thank you. And with my 1 minute left, Dr. Griffin, to you, your chart and report on fintechs and fraud was quite stunning to me. And not all fintech lenders, although, in that chart have high misreporting rates. Two of them, in fact, were among the better in the entire graph. So what features distinguish the fintechs with low misreporting rates from those with high misreporting rates in your estimation?

Mr. GRIFFIN. Great question, actually. I think the difference is two of the lenders that have very low misreporting rates will actually establish businesses that have been in the fintech business for a while. And most of the lenders with low rates of misreporting were kind of new lenders that developed—had little track record, little reputation to protect, and probably little in a way of established procedures. And so, with little reputation to protect, and nothing but potential or probably low potential of being prosecuted, some of these fintech lenders seem to have just opened the door to rampant mortgage fraud.

Chairman PHILLIPS. Okay. Thank you, sir. And with that, my time is expired. And now I recognize the gentlewoman from Texas

and the Ranking Member of this Committee, Rep. Van Duyne, for 5 minutes.

Ms. VAN DUYNE. Thank you, Mr. Chairman. Dr. Griffin, I would like to start by looking at some of your findings. In your testimony, you state that, quote, “Misreporting is not a simple function of getting money out the door quickly in 2020. In fact, the fraud at the end of the month of the program in May 2021 is four times the level at the start of the program,” end quote. This is an astounding finding and one that is really not discussed very widely. Can you talk to us more about why this is the case?

Mr. GRIFFIN. Yes. Thank you. Yes, it surprised us as well. Well, it appears to be that fraudulent networks kind of ramped up their activities in terms of getting more and more PPP funds, and probably knowing which fintech lenders would rubber-stamp these loans. I say that because we find that in the very geographies in round one—in round one and two where there is high levels of misreporting, in those same ZIP Codes where there is some levels of misreporting at rounds one and two. The rounds increased dramatically in rounds three and four.

So it seems—and we also find evidence that it spreads through social networks online. So we think that kind of people initially went in, got fintech loans, and then spread this through networks in a massive scale, and it increased over time. That also indicates that fraudsters are fairly sophisticated. And if we engage in such type of SBA lending again, they are going to likely target this on a massive scale.

Ms. VAN DUYNE. Well, that actually brings me to my next point. I want to turn to your fourth finding which you state that suspicious loans are being overwhelmingly forgiven at similar rates to other loans and very few are being prosecuted, indicating that substantial reforms in SBA lending are needed. This is concerning. And the SBA has, indeed, fully or partially forgiven 90 percent of all PPP loans as of July 10, 2022. So I am going to use your words, do you believe that we are giving a free pass to the fraudsters that are abusing the programs and American taxpayer dollars and the nation’s small businesses?

Mr. GRIFFIN. I have no idea why all these loans are being forgiven, quite frankly. I mean, SBA, themselves, recognizes it. There is a real problem with fraudulent loans. And so we were kind of shocked to find the rate that loans are being forgiven among the likely fraudulent and non are essentially the same. And so, I don’t understand that it would be a simple matter of any loan with a questionable indicator simply being flagged and waived to forgive that loan. And that procedure could take a while to thoroughly investigate.

I think there is much—as I mentioned in our paper, we are only using public data. So there is also a lot of private data that the SBA has access to and likely indicates the problem is even greater than what we identified in our paper.

Ms. VAN DUYNE. Wow. Have you or your team researched or examined fraud within the Economic Injury Disaster Loan Program, EIDL?

Mr. GRIFFIN. We did briefly look at it, and we do think that there is—it is not in the paper, but we did find quite a bit of fraud in EIDL as well.

Ms. VAN DUYNE. Do you have any idea? Do you have more information than just—I think we all—

Mr. GRIFFIN. I don't have the exact dollar amounts on my table, but it was a fraction of the program. It was quite a large. I mean, one of our indicators is the difference in jobs reported to the EIDL program as well as the PPP program. So you will see that some—there are many borrowers who said they had 10 jobs in their business when they reported to EIDL, and yet when they applied to PPP, they are only one person. And those loans—we also depend on timing. So these two representations were made almost at the same time. So it is very—there was a huge mismatch between the programs.

Ms. VAN DUYNE. In my last 40 seconds, I don't believe Members can have a full and thorough conversation on fintech lending without further exploring how they performed their last 2 years. Especially you had mentioned earlier, their performance from nearly \$800 billion PPP. So what is some of the top lessons that Members should take away from PPP fintech research?

Mr. GRIFFIN. Thanks. Well, I think some of the top lessons are that, to focus on getting money out the door quickly. It is not necessarily a great goal. We had traditional lending guidelines in place, and those lending guidelines could have been followed. We don't know why the traditional banks did better. But if you talk to people at traditional banks, they will say they followed the same process and procedures they used before. And those process and procedures, those due diligence procedures where banks actually had a stake and could lose money if the loans defaulted, those procedures seem to have worked a lot better.

So, in general, I think—I don't think it is a good idea for the government to give out money without—and allow lenders to give out this money without repercussions where they also have a skin in the game and lose money if the loans default.

Ms. VAN DUYNE. All right. Thank you very much. I yield back.

Chairman PHILLIPS. And the gentleman's time has expired—the gentlelady's time has expired. I am sorry. And now I recognize the gentlelady from New York and the Chairman of the Small Business Committee, Ms. Velázquez, for 5 minutes.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman, and Ranking Member. Ms. Klein, can you explain how underserved small businesses are susceptible to predatory lending practices, and why legislation is needed to ensure all small business loans contain fair and accurate disclosures about costs and terms?

Ms. KLEIN. Yes, thank you so much for that question Congresswoman and Chair Velázquez. As I noted in my testimony, though, the Truth in Lending Act was originally not applied to consumer—commercial transactions because it was assumed that businesses had access to financial, and, in some cases, access to legal expertise. And that is true for large firms, but it is certainly not for the smallest firms. And I think both Ms. Paterson and Sean gave some really good examples of the kinds of small firms that they work with.

And I think one of the things that is also really important, not only to understand is, you know, that these firms don't necessarily have this level of financial expertise. The other thing that is important to note is that in many cases, a small business owner's personal and their business finances are closely connected. So a small business owner often uses her personal credit score when she is applying for credit. She may pledge personal assets or make a personal guarantee against the financing that she is receiving.

And, often, when there is a mismatch between, sort of, income or revenues and expenses, she is drawing on her personal savings, where she is choosing not to pay herself so that she can meet her other financial obligations. And so, I think this assumption of who small business owners are that is, you know, the reason behind—not—and sort of applying the original Truth in Lending Act to commercial transactions just doesn't quite hold up.

So what we want is, we want business owners to be able to make the best choices that reflect their financial circumstances, their personal circumstances, their business circumstances. And that is why truth-in-lending-like disclosures are really needed for small business loans. So they have the information they need.

Ms. VELAZQUEZ. Thank you. And, Ms. Klein, my legislation, Truth in Lending bill, gives the CFPB regulatory authority to include small business loans and financing products. Given that CFPB already has jurisdiction over the Truth in Lending Act and Section 1071 of the Dodd Frank Act which vastly improves small business lending data collection, do you agree that CFPB is the appropriate federal agency for overseeing this space.

Ms. KLEIN. Yes, and I would speak here both wearing my Aspen Institute hat and the Responsible Business Funding Coalition hat. We agree that there is an extending framework at CFPB that is based on its oversight of existing protections to consumers, and that provides us a good foundation for extending these protections to small businesses seeking financing.

Ms. VELAZQUEZ. My legislation will create a federal regulatory floor, meaning that States can enact stronger protections than in federal law. However, I heard that to prevent jurisdiction shopping by online lenders, federal law should establish a ceiling instead and preempt State law in this space. What are your thoughts on whether federal law should preempt States in regulating this lenders and products?

Ms. KLEIN. So I say—our framework again as we start is to start with the interest of a small business owner. And from that perspective, your legislation H.R. 64, already does the most important thing, which is to require the rights of the disclosures that includes APR. And we think small business owners across the country deserve that information.

So with regard to preemption, I am going to speak based on my work at the Aspen Institute, and then if like, if needed, I will clarify later the formal position of the Responsible Business Lending Coalition. But from the perspective of my own work, I think a federal standard is really helpful. Many lenders, CDFIs, fintech lenders, other lenders work in multiple space, in some cases, nationwide, and having one set of required disclosures would be more efficient for them. It would enable—if we want financing costs to go

down over time, I think a strong national standard is the way to go.

Ms. VELÁZQUEZ. Thank you. And New York and California with both passed truth in lending laws for small business loans. And in implementing them, they carve out fraud plan financing and real estate investment property from the lost coverage. Are those exemptions something we should consider at a federal level?

Ms. KLEIN. Thank you. I think our preference as a Responsible Business Lending Coalition would be to have all small business lenders subject to the same requirements for all products. I think that creates a, you know, a level, regulatory playing field that doesn't preference some types of products or lenders over others, which I think is important. However, I will also note we did, you know, support the financial legislation that passed in California and New York.

Ms. VELÁZQUEZ. Thank you. I yield back, Mr. Chairman.

Chairman PHILLIPS. The gentlewoman yields back. And now I recognize the Ranking Member of the Subcommittee on Economic Growth, Tax, and Capital Access, the gentleman from Pennsylvania, Mr. Meuser for 5 minutes.

Mr. MEUSER. Thank you very much, Mr. Chairman. I thank the Ranking Member Van Duyne as well for holding this hearing. And thanks to all of our witnesses.

Certainly, I think we all know, small businesses today are facing tremendous challenges. It is somewhat of an endless list from inflation, to labor shortages, to all kinds of supply chain disruptions, unpredictable new regulations, and, of course, challenges to access to capital.

So, you know, Dr. Griffin, I am very interested in your testimony as well as the graphs and all that you provided us. So when you speak of the issues from the lending on PPP, you meant—related to fintech as well, of course, do you think that there is—is there an 80/20 rule, 20 percent or 80 percent of the fraud was coming from 20 percent of the participants? Would you say that is, perhaps, fair, or maybe you can elaborate on that some?

Mr. GRIFFIN. That is an interesting point. Yes. I think that the fraud is likely perpetuated by a smaller number of actors than you might think. Because our analysis shows that the fraud is concentrated in certain CBSAs. And even within those CBSAs, concentrated in certain ZIP Codes. That indicates that it is not just a few people getting this idea of randomly and applying for the loans, but rather organized networks, recruiting people, getting fees, maybe coordinating with other organizations to facilitate the fraud. So I think it is an organized—our evidence indicates it has an organized fashion to it, and that the likely number of players that were orchestrating, at least the rampant fraud, is probably more aligned with more like 5 percent of the people doing 90 percent of the 90 percent of the fraud.

Mr. MEUSER. Great. Thank you. Mr. Salas, I want to ask you a question, if I can, please. So what do you consider to be your biggest concerns, or your customers' largest concerns and their needs for access to capital? In a way, why does your company exist when, you know, there is community banks and everything else out there?

And also, what is your feeling about, you know, there is some fintechs, and some of the commentary that has been made here on these outrageous levels of nontransparent interest rates? I would like to hear your thoughts on that.

Mr. SALAS. Absolutely. And thank you for the question. In our experience, entrepreneurs have some clear market demands, and I just want to outline what those demands are. One is transparency; two is simplicity; three is affordability; and fourth is expediency.

At Camino Financial, we try to meet these demands for our borrowers in the most responsible and cost-effective way. And I do want to underscore to the second part of your question, the importance of transparency.

I recognize that there are bad actors in this industry that have over-anchored on one of those particular principles, which has been underscored by this Committee, expediency over transparency. And so we are proud Members of the Responsible Business Lending Coalition to show united front among those good actors in the industry that we care about these issues, that our underlying intention is to leverage technology, to effectively bring down the cost of distributing and transacting, which ultimately benefits our borrowers.

Mr. MEUSER. Okay. Good. Good. Mr. Griffin, I am going to come back to you for a moment. The idea of CFPB having authority over small business lending over fintechs, your thoughts? Good idea? Not a good idea? Your thoughts on that?

Mr. GRIFFIN. Well, I realize this is a very partisan issue, but I do think the CFPB does play a role to provide a different perspective on overseeing some of the predatory practices. So I have noted, I investigate fraud, and I look at which organization—I look at—I also talk to various government organizations. And one pattern that I notice is sometimes one organization will pick up on something and someone else may not. And it may be because of kind of exogenous reasons. So I am a fan for more data being available not just to government organizations but to the public to analyze these matters. So—and I completely share—

Mr. MEUSER. I am absolutely sorry. We are over our time. And I just want to say we want to get it right and not be partisan. And, Mr. Salas, I would like to get your response to that in writing or after this. And, Mr. Chairman, I yield back. Thank you.

Chairman PHILLIPS. The gentleman yields back. Now I recognize the gentlelady from California, Ms. Chu, for 5 minutes.

Ms. CHU. Mr. Salas, congratulations to Camino Financial for recently being approved as a U.S. Treasury-certified Community Development Financial Institution, or CDFI. As a mission-based lender, you are one of a small group of fintech lenders with a CDFI certification demonstrating your commitment to promoting community development and providing responsible, affordable capital and technical assistance to underserved, minority-owned small businesses. You are also one of the few fintech lenders that have voluntarily signed onto a Small Business Borrower Bill of Rights which commits you to fair business practices, including disclosing the true, complete cost of your product.

Mr. Salas, can you discuss why Camino Financial chose to sign onto the Small Business Borrower Bill of Rights, and how being a

signatory benefit to business? And what would you say to encourage other fintech small business lenders to join you.

Mr. SALAS. Thank you for your kind words and your question. I will say that becoming a CDFI has been a long-term bet that we know is a winning bet. It took us 3 years to get certified in multiple applications, as one of the first, if not the first digitally native CDFI with a national designation focused on small business lending. So we are proud to be a CDFI and appreciate the question.

Why did we sign the Borrower Bill of the Rights? Simply put, it was the right thing to do, because it is in the best interest of our borrowers, and it underscores guiding principles or guardrails of responsible lending in our industry.

And I encourage other fintechs to do the same. And if you don't, we are going to put you out of business.

Ms. CHU. Well, I also appreciate the fact that Camino Financial is pursuing a Community Advantage lending license with the SBA. Community Advantage is something that could benefit small businesses so tremendously if they had greater access to it. And because fintech lenders are much more likely to serve the smallest businesses unable to access products from traditional lenders, they are kind of going after the same market. And compared to the misleading advertising, some fintech companies use to track businesses in unaffordable loans with high interest rates, Community Advantage loans have a maximum interest rate of prime plus 6.5 percent, which is far below the nearly 50 percent we have seen in some parts of the fintech market.

Community Advantage lenders also provide their clients with technical assistance that some fintechs may not. I have long been a proponent for making Community Advantage programs permanent. And I was pleased to see that the SBA recently raise the moratorium on new lenders in the program of which you are one that is applying.

Can you tell us why you are pursuing this license and about how bringing more lenders into Community Advantage loan programs—into this program could potentially help more small businesses out of predatory unaffordable loan products?

Mr. SALAS. Absolutely. Excuse my excitement because I think this is one of the biggest opportunities to systematically lower the cost of capital to underserved small businesses. We believe that the extension in permanent implementation of the SBA Community Advantage Program presents a great opportunity to increase the accessibility.

Let me illustrate with how I believe Camino Financial would apply this program. We know and acknowledge that many underserved small businesses, on the day of their application, may actually not qualify for the Community Advantage program. And so, why do I think and believe that it is going to drastically bring down the cost? It is because we call ourselves Camino for a reason. We are not just your starting point, we are your end point. It is important that we not only offer you an affordable and accessible loan at the onset that may not be an SBA loan, but gives you the path to graduate into an SBA loan. And, unfortunately, today, as you know, SBA licenses are very hard to come by unless you buy a bank. But there is an opportunity as a CDFI to participate in

SBA loan programs, to be able to offer what I qualify, if not the lowest, some of the lowest prices available to these underserved communities.

Ms. CHU. And to follow up, the Community Advantage program was extended for 2 years. But would making the program permanent provide the certificate needed for lenders to participate?

Mr. SALAS. Yes.

Ms. CHU. Thank you.

Chairman PHILLIPS. We never heard a witness just say “yes” or “no.”

The gentlelady yields back.

And with that, I recognize the gentleman from Wisconsin, Mr. Fitzgerald, for 5 minutes.

Mr. FITZGERALD. Thank you, Mr. Chair.

Dr. Griffin, I think it would be wrong for us to have the hearing on fintech lending and not discuss Section 1071 of Dodd-Frank.

Since CFPB issued its proposed rule, I have heard from several financial institutions about the negative impact that this will have on both small banks and small businesses. Even CFPB Director Chopra expressed concern regarding the regulatory burden the proposed rule would have on small banks. But it is not just traditional institutions that would feel the effect of 1071. Nonbank lenders and fintechs would meet the 25 covered credit transaction requirement that will be subject to the same data collection burdens as other financial institutions. The results of this proposed rule will be fewer loans and decreased access to credit for small businesses.

I want to thank the Ranking Member, Ranking Member Luetkemeyer, for his leadership on this issue, including sending a letter to the director outlining the concerns of Small Business Committee Members with the proposed rule.

I would also like to submit that for the record if I could, Mr. Chair.

I would also be introducing a bill this month to repeal Section 1071 and require small business advocacy review panels to presume tailoring is necessary for rulemaking.

Dr. Griffin, can you elaborate on how Section 1071 reporting requirements are burdensome to small businesses?

Mr. GRIFFIN. Yeah, thanks.

Well, I am not an expert on 1071, but I will just say, I am not in favor of having additional reporting requirements for small businesses. I would—I favor, like, the SBA having authority to investigate if they see consumer or predatory loans, but in terms of additional reporting requirements on small businesses, that could be—I would see where that could be burdensome.

It would seem that the kind of data that I am requiring, or I would like to see more public transparency of, is data that is already collected. In terms of when loans are made, there is a lot of features to those loans, and that data could be made available by the SBA or the CFPB or other government organizations so that private individuals and academics like myself can investigate the data and look for misreporting.

Mr. FITZGERALD. Yeah. I mean, one of the corporations actually located in my congressional is Fiserv. And with the literally millions of transactions that happen on a daily basis, I think put-

ting fintech into kind of the same category and then saying that the same requirements that would apply to any type of traditional financial institution could also be accommodated by these corporations is just, well, first of all, naive; and, secondly, once again, kind of the heavy hand of government stepping in and saying, You know, we are going to require something that quite honestly we are not even sure whether or not they could provide.

So, I mean, do you think—like you said, you may not be an expert on the topic, but, you know, codifying Section 1071 for nonbank and fintech, it just doesn't seem like a good fit. Would you agree with that?

Mr. GRIFFIN. You know, again, I am not comfortable making an up-or-down decision on it without knowing more details. But I would say that fintechs, along with traditional banks, already collect a lot of information. So I would favor whatever information they are existing, collecting in their loans, and so forth, to make all of that data available to some reporting agencies, and that—if they simply did that, that would not require additional burdens. If they are requiring to give a survey to all of the customers, then, yes, that would be an additional burden. But just taking blanket downloads of the data they already collect and passing that on, I think that would be sensible, but that is probably not what the rule is about. But, anyway, I will—

Mr. FITZGERALD. Yeah. And I apologize if I am putting you go on the spot, and I know we are into kind of an area that no one has really had to dive into yet.

But the other thing I would just say in closing is when we looked at the PPP program and kind of the requirements and the financial institutions and the oversight that was obviously in place when you are talking about some of the small banks and credit unions, there was obviously much less fraud.

Again, I don't know how we apply these things when you are talking about fintech with the scale and the size of what these companies are doing. So, again, more of a comment than a question, I guess. I wish we would simply avoid that if we could.

And I yield back.

Chairman PHILLIPS. The gentleman yields back.

And now I recognize the gentleman from Florida, Mr. Donalds, for 5 minutes.

Mr. DONALDS. Thank you, Mr.—I am on? There you go.

Thank you, Mr. Chairman.

This is always an interesting topic for me considering the fact that a lot of the reasons why we are in this issue are respect to the new innovations is because banking regulation in the United States has actually been terrible. It has actually crippled community banking in the United States. We all know it. That is why you have had so many different aspects of innovation that have matriculated because the desire for small borrowers, small businesses, micro businesses, and people at the lower levels of our socioeconomic strata still need capital. They have still got to borrow money. And the banking system as it exists today cannot meet the demand because of the ridiculous regulations brought from previous iterations of Congress a decade ago, two decades ago, so on and so forth.

I stand still in the position today that Dodd-Frank even needs to go completely, or be completely reformed because what it actually did was cripple the ability for capital to reach some of the smallest enterprises in the United States.

That being said, Dr. Griffin, one of the reasons I have an issue with an expansion of CFPB's authority—which, by the way, the CFPB, in my view, is not constitutional because they have—there is no oversight authority from Congress for them to operate. They basically operate in the ether. And I know nobody likes to talk about that, but they do their own thing, and they literally leverage money from corporations with no oversight whatsoever from Congress.

So my purview, they are an unconstitutional body, they should be removed. Just figured we might as well get that on the record right now.

But that being said, my issue with actually expanding their authority is that—Dr. Griffin, do you think that it would make it harder for fintechs to actually be able to operate and provide capital to the people who still desire capital in the United States, specifically around small business borrowing, micro business borrowing? Do you think the Chairwoman's bill would actually make it harder for fintechs to meet the demand that obviously exists in the United States?

Mr. GRIFFIN. Yeah, thanks for that question. I mean, these are complex topics.

I would start by saying that I think, oftentimes, with regulation, there is two approaches. One is to try to create a lot of safeguards on the front end to prohibit potential problems on the back end. And there can be problems with that as our program—as we showed with the PPP, there were substantial problems with the program.

Now, we should always think about designing better programs, and so forth, but I am a big advocate, as I was mentioning at the end of my talk, of having stronger consequences at the back end. And whether that comes from existing organizations, like the Department of Justice, the Securities and Exchange Commission, or other regulatory bodies, perhaps the CFPB, I would have that to be more repercussions for organizations that violate the rules, rather than creating a lot of regulatory tape at the front end that could actually—because one of the problems with that regulatory tape at the front end is that it does prohibit new competition and can actually entrench those people that are able to navigate the rules, entrench those people in the market and actually cause, you know—prohibit new competition.

Mr. DONALDS. Well, I appreciate that.

And one other area I want to get on real quick—and I heard it in one of the witness's testimony earlier today was about APRs, at the annual percentage rate. Listen, as a banker—a recovering banker, because I am not in the industry anymore obviously—but as a recovering banker, you cannot—it has never worked to apply short-term loans and subject them to APR calculations. The debt is only outstanding for a week, 2 weeks, maybe 3 weeks, and you are going to apply an annual percentage calculation to it? The APR, quote/unquote, might sound technically right, but the prob-

lem is that the credit is not extended for a full year. So it is—you are comparing apples and oranges. It just never has really made much sense to try to apply APR terms to some of these short-term lending instruments that are designed to be short-term that are short-term.

Dr. Griffin, last question to you in the time remaining. Do you think that it is actually beneficial to these borrowers to have these APR disclosures which, in my view, are misleading anyway?

Mr. GRIFFIN. Yeah, I actually disagree with you on that. I would like to see the APR disclosed. And if there are caveats, like the APR would only be for a certain period of time, they could disclose that, that if the loan is only for X months. But the one problem is, if the loan is, like, only like a month originally but then it extends to a longer term, then it could end up being an APR.

So I do think that transparency and giving accurate information to borrowers and putting all of the information on a level playing field so that borrowers can make the appropriate choices—I am a finance professor, and I can tell you that sometimes my colleagues are confused by some of the terms in various documents. So I do think there is some role to transparency and putting things on a level playing field, for better competition that way, actually.

Chairman PHILLIPS. And the gentleman's time has expired.

And seeing no other questions, I want to thank all of our witnesses for being here today. New technology can expand access to timely credit for underserved entrepreneurs, increase financing options, and improve day-to-day operations for small businesses. But as we have seen today, these new technologies have also been used to take advantage of entrepreneurs.

As a Congress, we must take steps to ensure that this rapidly developing sector has adequate protections for small businesses. Today, we have discussed several commonsense policies, from transparency policies to disclosure policies, that can help root out predatory practices and ensure fairness for small business borrowers around the country.

So I look forward to working with my colleagues on both sides of the aisle to advance solutions that expand access to affordable capital while safeguarding small firms.

Without objection, Members have 5 legislative days to submit statements and supporting materials for the record.

And without any further business to come before the committee, without objection, we are now adjourned.

[Whereupon, at 11:15 a.m., the subcommittee was adjourned.]

APPENDIX

Testimony of Sean Salas
Chief Executive Officer and Co-Founder, Camino Financial
U.S. House of Representatives Committee on Small Business
Subcommittee Hybrid Hearing: “Fintech and Transparency in Small Business Lending”
Wednesday, July 13, 2022

Chairwoman (Nydia) Velazquez, Ranking Member (Blaine) Luetkemeyer and Subcommittee Chairman (Dean) Phillips and Ranking Member (Beth) Van Duyne and other members of the subcommittee, thank you for having me here today.

My name is Sean Salas and I’m the co-founder and chief executive officer of Camino Financial.

Camino Financial is an AI-powered lending platform that empowers entrepreneurs to grow their business and boosts access to capital for underserved communities. Our microloans provide small business owners with the flexible financing they need to thrive in a competitive market.

We are a national community development financial institution, or CDFI, that is pioneering affordable credit through technology and AI. Our mission is to build generational wealth in underserved communities. We take a digital first approach and Applications are 100 percent online. We predominantly serve entrepreneurs in California, but our digital-first approach allows us to serve businesses in other states.

Today, I’m proud to say that we’re the largest Latino-focused small business lender in the United States. We did this by providing a “camino” or a pathway to capital by educating our borrowers. This pathway involves providing resources that teach them how to formalize their business and access the tools they need to get on a “path” to qualify for larger, lower-interest rate loans.

I founded Camino Financial with my brother, Kenny, while completing our MBAs at Harvard Business School. We are the sons of a Mexican entrepreneur, who truly sought the American Dream. Our mother opened over 30 restaurants in Southern California while raising six children, but when I was 12 years old her entire business collapsed. She moved us to Mexico to restart our lives, despite us being U.S. citizens.

When you’re a twelve-year-old kid and you see your mom lose her business, there’s a fire that lights in you that doesn’t go out. There was no lightbulb moment for starting Camino Financial. The moment Kenny and I graduated from high school in Mexico, we decided to immigrate back to the U.S. to pursue what my Mom had lost, the American Dream. We were lucky enough to be admitted to UC Berkeley and thereafter build our careers in finance. While working in finance, we first realized the capital gap for investing in micro businesses in minority communities. So, we decided to leverage our MBA experience to incubate Camino Financial, to help businesses, like my mother’s, grow to a point where they can access a broader suite of wealth building solutions.

The average Latino business earns \$250,000 in revenue, that's about roughly half the national average. Most of Latino-owned businesses are micro businesses, not even small businesses, with 4 or less employees. Banks and larger institutional investors do not actively service over 97 percent of the Latino business credit market, leaving a gap that we measure to be north of \$20 billion in unmet capital demand.

Ultimately, we provide opportunities to one of America's fastest growing business segments, one that is critical to the ongoing growth of the U.S. economy. If Latinos don't build wealth, America does not build wealth. And as we know, entrepreneurs are the bedrock of building wealth in our communities.

We work with the most underserved entrepreneurs in construction, retail, transportation, restaurants and bars, as well as other professional services, such as janitors and landscapers that are the beating heart of nearly every community.

I'd like to share with you a few examples of the types of entrepreneurs we help:

In Long Beach, California, a Latino entrepreneur needed a loan to buy equipment to take on more work and hire more employees for a small business that performs car detailing and cleaning services.

In Los Angeles, a small restaurant owner used our loan for working capital during the pandemic and to bolster sales by 70 percent and has since opened a new location.

Another business in Los Angeles, used our loan to buy a new smog check machine for their small auto repair and smog check station.

And a Latina small business owner in Highland Park, used our loan for inventory purchases to expand her art supply and home decor store. As a result of our loan she expanded her business and took on a new location.

Because we are a digital-first company, transparency has been critical to our success. I know today's hearing is on fintech and transparency in small business lending. And while I'm not here to talk about our competitors, what I can tell you is that transparency is critical to our business.

Whether it's to our investors or borrowers, our credibility is based on our transparency with both costs and risks. We know our members shop around for the best deal, and by being transparent, our clients feel reassured they're comfortable with the payment structure and making the right decision.

In the end, our business is about helping more entrepreneurs achieve the American Dream. So many people like our mother attempt to achieve this dream without advanced skills and degrees, but with the drive and ambition to succeed and provide for their families. We believe

that what we're doing— providing capital as well as resources that educate entrepreneurs on cash flow, financials, and other core business practices—is important to helping more underserved entrepreneurs and communities succeed.

Through our financial platform, over the last 6 years we've helped over 9,500 small businesses across the U.S. scale and succeed. It's my hope that as we continue to grow, we'll help many more budding entrepreneurs live the American dream.

Thank you for the time and the privilege to speak today.



Testimony of Joyce Klein

Senior Director, Business Ownership Initiative, The Aspen Institute

Provided to the Committee on Small Business Subcommittee on Oversight, Investigations and Regulations

“Fintech and Transparency in Small Business Lending”

July 13, 2022

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

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

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

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

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

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

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

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

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

¹ Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," 2016. https://aofund.org/app/uploads/2021/03/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

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

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

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

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

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

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

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

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

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

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

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

- 1. The Right to Transparent Pricing and Terms:** A borrower has the right to have the cost and terms of any financing being offered presented to them in writing, including the APR, and in a form that is clear, complete, and easy to compare with other financing options, so they can make the best decision for their business.
- 2. The Right to Non-Abusive Products:** A borrower has the right to expect that the financing products offered by a lender will not trap his/her business in an expensive cycle of re-borrowing.
- 3. The Right to Responsible Underwriting:** A borrower has the right to expect a lender is offering financing based on underwriting practices that assess the ability of the borrower’s business to succeed and repay.
- 4. The Right to Fair Treatment from Brokers:** A borrower has the right to honest, transparent, and impartial communications with a broker regarding loan options, conflicts of interest, fees, and the financing options available.
- 5. The Right to Inclusive Credit Access:** A borrower has the right to fair and equal treatment when seeking a loan including protections guaranteed under the Equal Credit Opportunity Act.
- 6. The Right to Fair Collections Practices:** A borrower has the right to be treated fairly and respectfully

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Small Business Committee
 Subcommittee on Oversight, Investigations and Regulations
Fintech Transparency in Small Business Lending

Good Morning Committee Members. It is an honor to testify today at this hearing. My name is Diane Paterson and I am the Regional Director of the Twin Cities Small Business Development Center, hosted by the University of St. Thomas.

With today's online credit lending environment, where many Fintech services offer a four-minute application and 24-hour turnaround to access funds, the SBDC is seeing small business owners navigating confusing fine print, adverse interest rates, loan terms, and early pay back penalties that have the power to put them out of business.

These lending practices are especially harmful to small, young, less profitable, and minority-owned businesses, who already struggle to access financing because they lack the business history or collateral that traditional banks require. Yes, the ease and speed with which small business borrowers can access Fintech credit is appealing and even beneficial. But these businesses tend to use this loan option in conjunction with other forms of credit, making them financially vulnerable.

The application process for a traditional lender takes days. The approval process itself can take weeks, or longer depending on the meeting schedule of the loan committee. Standing in stark contrast, two Fintech options- Biz2 Credit and Blue Line, advertise four- and five-minute completion times respectively. Both promise next-day availability of funds. While Fintech loans address pain points in the loan application process, these loans subject borrowers to much higher interest rates and other terms that cause many to default.

The biggest issue in Fintech lending practices is the lack of transparency in the price of their products. As consumers, we are accustomed to seeing rates of 3.5% to 4.5%, APR. This commonly understood Annual Percentage Rate terminology is familiar- it makes sense. Fintech borrowers READ rates ranging from 3.5%-4.5%, and assume they are APR. What they do not realize is that the Fintech rates are regularly calculated on a DAILY basis. This results in a lending relationship that subjects the borrower to an interest rate in the range of 58-63%. Simply put, Fintech's lending practices are an issue, with this daily calculation the first of several fine print problems.

Kabbage for example, advertises a "Loan Fee" instead of an interest rate. OnDeck's interest rates are clear, but they range from 24.6%-58.5%. Lending Club, charges 9.77%-35.71% interest, and then assigns an additional loan Origination Fee, ranging from 1.99%-8.99%.

The cost of Fintech credit is high. The terminology is confusing. Adding more fuel to the fire, the repayment terms of many Fintech loans are becoming problematic for borrowers. Fintech loan

repayment terms are traditionally very short- six-twelve months in most cases. This greatly impacts the level of the borrower's monthly debt service. While many Fintech lenders offer weekly installments, this doesn't change the reality that these payments are often too large for a small business' cash flow to digest.

To illustrate, a client of the Small Business Development Center founded a craft brewery operation making gluten-free beer. Due to the nature of their product, they were unable to brew beer using another craft brewer's equipment during the startup phase. As such they financed "new" machinery using a \$375,000 loan from a bank. The taproom was an instant revenue generator, but their revenue from distribution lagged behind their projections.

They approached their bank for a second loan for \$100,000 to cover working capital, to bridge until the distribution side of the business caught up, but the application was rejected. The brewery had no choice but to seek a \$100,000 loan with OnDeck, thinking the interest rate was comparable, or lower, than the bank. The interest rate in reality was 58.6%, with the term of the loan only twelve months. The debt service (principle and interest) payable per month was \$11,208.00.

Our office intervened on behalf of our client and asked the original bank to reconsider. The bank initially refused because the \$100,000 loan was also subject to a \$20,000 pre-payment penalty, pushing the principle owed to \$120,000. We worked with the bank to help them understand that without their help, the brewery would likely default on the bank's original loan PLUS the Fintech financing. To ensure the viability of the company, the bank ultimately chose to refinance the Fintech loan. While very positive, this outcome is rare- most businesses would have no choice but to default.

Strong guidelines driving uniformity in Fintech lending practices and fine print language, clearly focused on the borrower's ability to repay, will give consumers the ability to compare loan options apples to apples, and reduce the number of borrowers who default. With new business startups at an all-time high, now is the time to address this issue.

Testimony by Professor John M. Griffin, Hearing on “Fintech and Transparency in Small Business Lending” by The Small Business Subcommittee on Oversight, Investigations, and Regulations

Chairman Phillips, Ranking Member Van Duyne, and members of the Committee, thank you for inviting me to appear before The Small Business Subcommittee on Oversight, Investigations, and Regulations today to speak with you about FinTech lending. My name is John M. Griffin, I am a finance professor in the McCombs School of Business at The University of Texas at Austin. I am also the CEO of Integra FEC, a small financial consulting firm in Austin, Texas that focuses on investigating complex financial fraud. As a finance professor that focuses on forensic finance, or the investigation of fraud and potential misreporting in financial market, I think it is important to thoroughly investigate the past in order to guide justice and future policy.

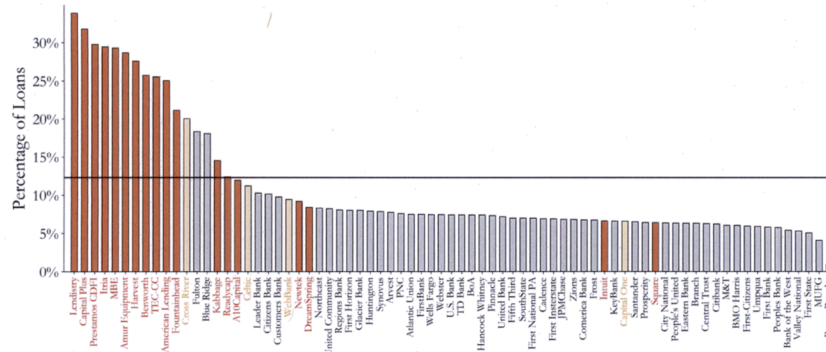
This testimony is based on my paper with my coauthors, Professor Samuel Kruger and Prateek Mahajan, entitled, “**Did FinTech Lenders Facilitate PPP Fraud?**” which is found on the Social Science Research Network (SSRN) at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3906395. I will summarize some of the main findings from our paper and then briefly discuss potential policy implications.

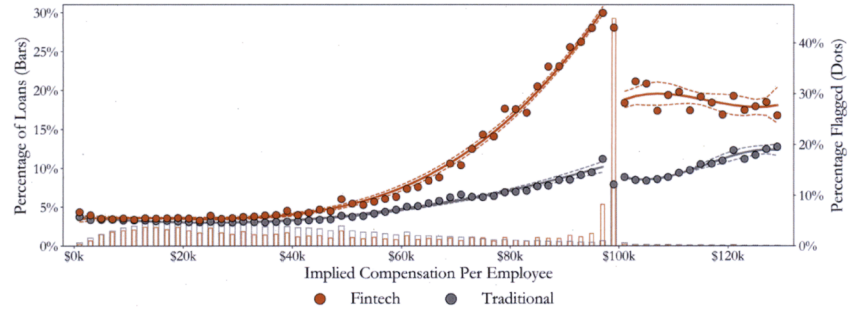
Our paper analyzes the SBA’s Paycheck Protection Program (PPP) based on four main metrics/flags and seven additional flags related to potential misreporting. Four main findings of the paper are: 1) The flags for potential misreporting consistently concentrates in FinTech, with the 12 lenders with the most misreporting all being FinTech lenders. Overall, FinTech loans are 6.52 times as likely to be fraudulent. 2) Misreporting is not a simple function of getting money out the door quickly in 2020. In fact, the fraud at the end of the program in May 2021 is four times the level at the start of the program. 3) The amount of likely fraud is quite high. Our four main measures, which are cross-verified by seven additional measures, place the likely level of misreporting at 1.41 million questionable loans representing \$64.2 billion in capital. However, when we take a broader look at potential misreporting, we find a total suspicious lending estimate of \$117.3 billion. Since these analyses use only public data and take a conservative approach, the total amount is likely even larger. 4) Suspicious loans are being overwhelmingly forgiven at similar rates to other loans, and very few are being prosecuted, indicating that substantial reforms in SBA lending are needed.

Let me give some brief background of FinTech lending in the PPP. The PPP rapidly distributed over \$793 billion of funds in three short rounds between April 2020 and May 2021. Although FinTech lenders began slowly with less than 5% of loans in round 1, they ramped up to over 80% of loans by May 2021, highlighting their growing importance. FinTech lending was recognized by the media and academics for broadening access to PPP loans, particularly to smaller firms without pre-existing lending relationships with traditional banks, and for facilitating quick and efficient lending when many small businesses were in need of funds due to the COVID-19 pandemic. However, the rapid expansion of FinTech lending may have come at the expense of underwriting standards. Whereas traditional banks have established borrower relationships and extensive Bank Secrecy Act (BSA) compliance programs, many FinTech lenders had few established relationships and may have been less diligent when establishing formal procedures with little reputation to protect.

Our paper examined whether FinTech lenders prevent or facilitate fraud in the PPP, and how potential fraud and misreporting vary across individual lenders. To investigate these questions, we perform a big data analysis of loan features for the 11.5 million PPP loans with eight disparate datasets. We introduce four primary and four secondary indicators of whether a loan is potentially fraudulent, which we then validate with three independent external measures. Each indicator creates an inference that a loan is

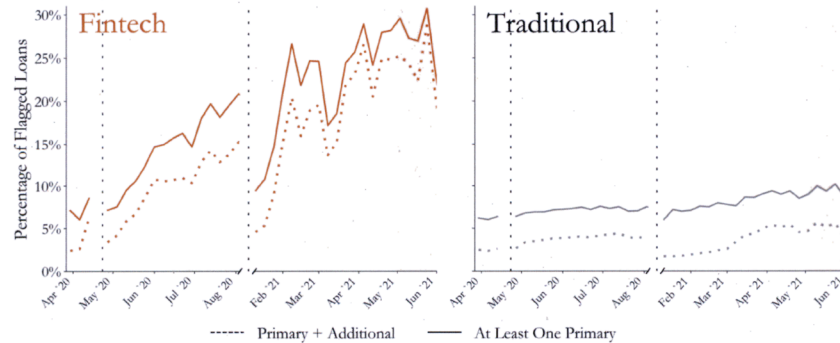
As shown in Figure 5 from the paper (reproduced below), the percentage of flagged loans increased as one approached the perceived \$100k threshold. This is true for traditional lenders in grey dots, but much more prevalent for FinTech lenders in red dots.





A basic interpretation of this figure is that fraudsters maxed out the amount of cash they could receive, and this was particularly true for loans through FinTech lenders. Additionally, in many U.S. counties the number of businesses in an industry-county pair frequently exceeds the number of establishments listed for that industry and county in U.S. Census data. For FinTech lenders, 39.3% of loans exceed industry-county establishment counts, and 32.6% of loans exceed industry-county establishment counts by a factor of more than two. Additionally, we found repeated use of recurring loan features, and in ways that were likely improbable. For example, we found 938 loans all in downtown Chicago for miscellaneous crop farming, all for \$20,000. These patterns were not isolated and are present in many zip codes and counties across the U.S., indicating the potential spread through criminal networks. Finally, FinTech borrowers are more than 3.4 times as likely to have a felony record, and borrowers flagged for potential misreporting based on the primary and other secondary measures are also more likely to have felony records.

A common reaction to our paper is that the higher level of fraud may be ok because the design of the program was to get money out the door quickly. However, an interesting finding is that the fraud through FinTech lenders got worse throughout the program. There were particularly high rates in the last month of round 3 (25.0%) as can be shown in Figure 10 of the paper (reproduced below).



Lenders with high rates of misreporting in rounds 1 and 2 increased both their misreporting rates and their loan volume in round 3, which indicates that their due diligence process was not improving. For example, the four largest FinTech lenders exhibited high rates of misreporting and large lending volume growth while generating approximately a billion dollars in processing fees each. Finally, FinTech lenders often doubled, tripled, or even quadrupled their lending in zip codes with high levels of potential misreporting in rounds 1 and 2 while also substantially increasing their misreporting percentages.

Overall, we find 1.41 million questionable loans representing \$64.2 billion in capital with our primary measures. While these measures inevitably contain some false positives, the measures also miss many forms of suspicious lending. Slightly lowering the threshold on the high implied compensation and considering excess loans in industry-county pairs beyond the number of establishments reported by the U.S. Census results in a total suspicious lending estimate of \$117.3 billion. Moreover, this sensitivity analysis is along only two limited dimensions. It is important to note that our estimates take a very conservative view of potential misreporting. For example, none of our measures consider whether the loan request was “necessary to support the ongoing operations” or whether the funds were used for “unauthorized purposes.”

Our findings have important policy implications. First, the PPP did not include robust verification requirements, and traditional banks may have been more apt to follow standard lending practices than new FinTech lenders. The lack of rigorous verification for PPP loans seems to have led to substantial costs to taxpayers, especially in 2021 when there was likely also less urgency to the loans. Second, FinTech lending, though found to be successful at adapting to new environments and quickly disbursing funds in other papers, needs to improve due diligence practices. Two established FinTech lenders persistently have low rates of misreporting, indicating that FinTech lending need not be substandard. Third, our evidence, along with evidence that the PPP saved relatively few jobs at a high cost, (Autor et al. 2022; Chetty et al. 2020; Granja et al. 2020), providing growing evidence that the PPP may not have been an efficient source of capital allocation and perhaps indicate that SBA lending may not be effective source of government spending. Fourth, incentives in the PPP appear misaligned in that FinTech lenders with widespread indicators of misreporting made billions of dollars dispersing loans with apparently lax oversight procedures. The FinTech organizations who facilitated such massive frauds should be thoroughly investigated and not be allowed to engage in future SBA lending. Fifth, the increasing scale of misreporting through time indicates that current penalty and enforcement systems are not effective. If the system is not changed for future SBA lending programs, the most likely outcome is even more of the same. Government agencies can assist this transparency goal by making detailed data available to the public.

Finally, much more needs to be done to align future incentives by prosecuting past financial crime, particularly in the PPP. Tax payers have been defrauded billions of dollars and our analysis shows that less than one in 10,000 loans that we identify has been prosecuted. To the contrary, over 90% of suspicious loans are being forgiven by the SBA. Much more can be done. Without prosecuting the organizations and networks of individuals who stole billions of dollars from U.S. taxpayers, justice is not served and wrong incentives are created for the future. If history is any guide, these same individuals and organizations will defraud tax payers again. This again is just a high-level summary, and many more detail can be found in our paper. Thank you again for your attention to these important issues. I look forward to further questions.



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July 13, 2022

The Honorable Dean Phillips
Chairman
Subcommittee on Oversight, Investigations,
and Regulations
House Committee on Small Business
Washington, DC 20515

The Honorable Beth Van Duyne
Ranking Member
Subcommittee on Oversight, Investigations,
and Regulations
House Committee on Small Business
Washington, DC 20515

Dear Chairman Phillips and Ranking Member Van Duyne:

On behalf of the Electronic Transactions Association (ETA), I appreciate the opportunity to submit this statement for the record before the Subcommittee's hearing, "Fintech and Transparency in Small Business Lending." A series of the concepts being discussed may affect innovation and the use of technology in financial products and services for consumers and small businesses.

ETA is the world's leading advocacy and trade association for the payments industry. Our members span the breadth of significant payments and fintech companies, from the largest incumbent players to the emerging disruptors in the U.S and in more than a dozen countries around the world. ETA members make commerce possible by processing approximately \$22.5 trillion annually in purchases worldwide and deploying payments innovation to merchants and consumers.

Online Lenders and the Paycheck Protection Program

Small businesses are vital for America, however, these businesses routinely lack access to necessary capital to maintain and expand operations. Such access is particularly important as these small businesses across the country work to recover from effects of the pandemic.

Fortunately for small businesses, ETA's members are providing flexible and affordable access to capital that can help small businesses expand payrolls, pivot business models, and navigate inflation and supply chain disruptions. As evident of their participation in the Paycheck Protection Program¹ (PPP) online lenders used sophisticated, data-driven processes to reach funding decisions quickly and efficiently. This expeditious process allowed the small businesses to cover operational costs during a time it is needed the most.

The pandemic not only increased the need for capital among small businesses but also exposed the gaps in the credit markets. According to the Federal Reserve Bank of New York²:

- Online lenders were critical to delivering PPP loans to underrepresented populations including Black-owned businesses during the pandemic. The research indicates that about 1 in 4 Black-owned companies applied with online lenders.
- 95% of traditional financial institution applicants showed that applicants had prior relationships. Online lenders were able bridge the gap and provide financial support to most applicants, even those without a direct relationship to a financial institution.
- Online lender's loan sizes were smaller, and the number of loans increased five times from Round 1 (where online lenders were not initially included) to Round 2, while traditional financial

¹ As of April 2021, ETA members have helped the SBA process and disburse more than \$145 billion in PPP loans to nearly 2.5 million small businesses.

² <https://libertystreeteconomics.newyorkfed.org/2021/05/who-received-ppp-loans-by-fintech-lenders/>



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institution loan sizes and amount remained relatively the same. The smaller loan sizes and larger quantity of loans facilitated by online lenders highlights how crucial they were in getting these financial lifelines to more and more small businesses with fewer employees that were most in need.

The PPP demonstrated that online lenders are able to provide capital to small businesses not usually reached by traditional institutions and the impact to those businesses was substantial. ETA recommends policymakers support ways to broaden the base of the lender participation in the SBA 7(a) program, such as the *Expanding Access to Affordable Credit for Small Businesses Act*, which would lift the existing cap on Small Business Lending Company licenses and permit online lenders to participate in 7(a). The SBA should also continue to work with existing guaranteed lenders to adopt technological tools that will allow them to reach all types of small businesses.

Applying the Truth in Lending Act to Small Business Lending

America's small businesses are the engine of our economy and should have transparent and competitive options available to them for growth. ETA believes that small businesses deserve common sense disclosures for small business financing products that allow small businesses to understand and acknowledge the cost of credit and other terms and agreements so borrowers can better understand and easily compare commercial financing. ETA believes in disclosure policies that increase transparency for borrowers as well as reducing regulatory burdens and hurdles that increase costs on small businesses.

However, it is imperative that policymakers not conflate consumer lending with small business lending. Commercial and consumer credit are distinctly different types of credit. Small business borrowers have different needs and objectives in obtaining credit than consumers – often relying on financing to buy inventory, smooth cashflow, and expand their marketing. ETA cautions that an approach that would simply apply existing requirements for consumer lending to small business loans would have detrimental effects for both online small business lenders and the small business community. Particularly, because ETA member small business lenders are providing access to credit to businesses that are traditionally underserved and unable to access financing through more conventional means

Providing an Annual Percentage Rate (APR) or estimated APR disclosure includes a number of challenges for both small business financing companies and small businesses themselves when they seek to compare financing costs across products – especially for loans with terms less than one year. While APR may be well suited to gauge the cost of a mortgage or auto loan, APR is a poor measure of the cost of a small business loan and other innovative lending products created by fintechs. As economist Thomas Sowell has pointed out, "Using this kind of reasoning - or lack of reasoning - you could... say a hotel room rents for \$36,000 a year, [but] few people stay in a hotel room all year."³

Rather Total Cost of Capital (TCC) is more useful for comparing the absolute cost of commercial financing with a small business's expected return from investing the financing proceeds. A business that expects a short-term return on its investment would likely choose a financing product with a shorter term and higher daily, weekly or monthly payments to minimize TCC, even though that financing product is likely to have a higher APR or estimated APR.

The clearest cost disclosure is the dollar cost of credit or TCC, which is what matters to small business owners, and what most of the industry is already providing and what the industry should be providing across all products. Total cost is readily calculable and provides the clearest basis for comparison among commercial finance options, no matter how they are denominated (loan, purchasing of future receivables, factoring, equipment lease).

³ Payday Loans at <https://www.nationalreview.com/2011/11/payday-loans-thomas-sowell/>



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ETA and its members provide transparent disclosures to small businesses to help borrowers understand the true cost of a loan. In passing TILA, Congress intended that nothing be hidden and that the most important disclosures be highlighted. For long-term loans, such as mortgages and auto credit, APR seems like the correct choice. But for loans to businesses with terms of a year or less, APR is not the correct metric to supply to borrowers.

* * *

Considering the tangible benefits of such technological advancements, ETA urges policymakers to remain thoughtful and forward-thinking in how to best support industry's on-going efforts to provide opportunities for all consumers to access and benefit from innovative financial products and services. Efforts by policymakers to regulate financial products and services should be done collaboratively with industry participants and with careful consideration of the many types of business models and products in the marketplace. ETA stands willing to work with the Subcommittee and other interested parties to refine these proposals and to create a positive legislative environment.

If you have any questions, please contact me or ETA's Senior Vice President of Government Affairs, Scott Talbott, at stalbott@electran.org

Sincerely,

A handwritten signature in blue ink, appearing to read 'J. Patchen', is written over a light blue rectangular background.

Jeff Patchen
Director of Government Affairs
Electronic Transactions Association





July 13, 2022

The Honorable Dean Phillips
Chairman
Subcommittee on Oversight, Investigations,
and Regulations
House Committee on Small Business
Washington, DC 20515

The Honorable Beth Van Duyne
Ranking Member
Subcommittee on Oversight, Investigations,
and Regulations
House Committee on Small Business
Washington, DC 20515

Dear Chairman Phillips and Ranking Member Van Duyne:

On behalf of the Innovative Lending Platform Association (ILPA), I appreciate the opportunity to submit this statement for the record on behalf of our members before the Subcommittee's July 13, 2022 hearing, "Fintech and Transparency in Small Business Lending."

According to the committee memorandum, there are a number of issues this committee is looking to address that ILPA is uniquely qualified to provide input and expertise.

ILPA is the leading national trade organization for online lending and service companies serving small businesses. Our members (BFS Capital, Biz2Credit, Bluevine, Fundbox, Funding Circle, Kabbage, Lendio, Mulligan Funding, OnDeck, and PayNet) offer various commercial financing products to hundreds of thousands of small businesses so they have working capital to invest in their business, purchase inventory, hire additional employees, expand the business, and repair damaged or outdated equipment.

Online Lenders Impact on the Commercial Lending Market

The small business credit market has changed significantly since the financial crisis of 2008 and perhaps most materially with regard to the segments of the population that are predominantly and best served by certain types of lenders. According to the Federal Reserve¹ fintech lenders:

- now disproportionately provide more access to credit to underserved communities than traditional financial institutions²

¹ <https://www.philadelphiafed.org/the-economy/banking-and-financial-markets/the-impact-of-fintech-lending-on-credit-access-for-us-small-businesses>

² <https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf>

- lent more in zip codes with higher business bankruptcy filings and higher unemployment rates
- internal credit scores were able to predict future loan performance more accurately than the traditional approach to credit scoring
- have a potential to create a more inclusive financial system, allowing small businesses that were less likely to receive credit through traditional lenders to access credit and to do so at lower cost.

Fintech lenders are filling a significant portion of the credit access gap. Yet significant barriers remain preventing small businesses in the U.S. from accessing capital to start and grow their businesses. Compared to pre-pandemic levels, the share of applicants receiving all of the funding they sought fell from 51% in 2019 to 31% in 2021³.

Disclosures in Online Small Business Lending

ILPA has been the industry leader on the forefront of voluntarily providing and advocating for model disclosures that provide small businesses with comprehensive metrics that empower them to compare costs, terms, and other critical metrics across different providers and products. In 2016, ILPA created an industry-first model disclosure tool – the SMART Box® – that presents small business borrowers with comprehensive pricing metrics and identifies key loan terms in plain, easy-to-understand language.

In order for a free and fair market to operate most efficiently and cost effectively, ILPA believes federal commercial disclosures must:

- provide comprehensive and appropriate terms up front in order to facilitate comparison shopping and competition
- apply to all lenders of all types that offer commercial financing products
- be uniform across all 50 states and territories allowing for a single disclosure nationwide rather than a patchwork of state mandated disclosures
- be distinct and different from consumer lending disclosure laws, regulations and enforcement because of the entity, use of proceeds and nature of the risks

³ Federal Reserve Bank, 2022 Small Business Credit Survey: Report on Employer Firms, <https://www.fedsmallbusiness.org/media/library/FedSmallBusiness/files/2021/2022-sbcs-employer-firms-report> [hereinafter 2022 Fed Employer Survey].

- be supervised by the Federal Trade Commission, an entity best equipped to handle commercial financing activities

Each of these features are critical to ensuring small businesses are able to comparison shop in order to find the most appropriate financing option at the best price which spurs more competition and lowers costs in the market.

Costs Associated with Small Business Loans and Financing Products

The costs of small business loans and financing products vary greatly based on multiple factors that are unique to lending to for-profit businesses and distinct from consumer loans. Most U.S. states exempt commercial financing from usury rate caps because commercial lending and the risks associated with it are inherently different from consumer lending and ignoring this fact risks restricting access to capital and economic growth. Therefore, concerns regarding bank and Fintech lending partnerships that circumvent nearly non-existent commercial rate cap laws are misguided and we caution those who seek to conflate the need for consumer protections with the real costs of applying them to commercial lending. To illustrate this point, research by the Aspen Institute shows that to make an 18-month, \$5,000 small business loan at 15 percent interest recovers only 45 percent of the \$2,000 cost to make that loan. To fully cover the origination cost, a \$5,000 loan would have to carry a 40 percent interest rate to just break even⁴. Most small businesses are looking for shorter term unsecured loans under \$150,000 to satisfy a short-term liquidity event and the costs associated with making those kinds of loans are dependent on the kinds of lenders that are willing to offer that product, their costs of capital, the fixed costs of making the loan, and the risks associated with the business, industry and beneficial owners.

Whatever the costs of a commercial loan, we believe the best policy for lawmakers to consider is to ensure those costs are fully transparent to the applicant whenever a loan offer is made which allows the ownership of that business to comparison shop and decide the best financing product that fits their business' unique needs.

Confessions of Judgment (COJ)

COJs are a legal clause that can be found in some small business lending product loan contracts that requires borrowers to agree in advance to bypass litigation and pay amounts due on an event of default. While originally designed as a means to reduce the costs and time to facilitate collections and recoveries of delinquent or defaulted loans, [media reports](#) found egregious misuse of the procedure by certain funding providers, leaving small business owners with no recourse. It is important to note that the use of COJ is not widely used or limited to merchant

⁴ https://assets.aspeninstitute.org/content/uploads/2018/03/The-Price-of-Access-How-Scale-Focused-Microlenders-are-Pricing-for-Growth.pdf?_ga=2.50823145.1990510104.1571254877-1990074052.1571254877

cash advance companies and that many community financial development institutions have the clause in their own loan contracts. Regardless, ILPA believes that protecting small businesses by preventing predatory lenders from abusing the legal procedure is more important than preserving it to legitimately reduce costs for other lenders.

Fintech Lenders in SBA's Paycheck Protection Program (PPP) and 7(a) Program

The U.S. Treasury and SBA's decision to leverage non-bank state licensed and regulated fintech lenders in the PPP ensured the smallest of small businesses including minority owned businesses – traditionally the most historically-underserved groups by banks and traditional lenders -- were able to access program funds, largely through fintechs. New York Federal Reserve research⁵ concluded that:

- Financial technology firms (“fintechs”) served borrowers who would not have received loans otherwise
- Applicants who approached fintech lenders for PPP loans were more likely to lack banking relationships, be minority-owned, and have fewer employees
- A higher share of applications by Black-owned businesses were approved by fintech lenders as compared to firms with white, Asian, or Hispanic owners
- Black-owned businesses were approved for loans by fintech lenders at a higher rate even before the pandemic, suggesting that historical factors that have prevented Black owners from receiving bank credit continued to operate with the PPP

Since the PPP ended, multiple governmental and academic institutions have published research showing the overwhelmingly positive impact Fintech had on helping keep workers paid and businesses whole while the economy went into freefall. This includes Professor Sabrina Howell from New York University who published research in October 2021 that examined the use of automation in PPP lending⁶. Among other things, Prof. Howell's researched concluded:

- Fintech lenders with the most automated lending systems made 26.5% of their PPP loans to Black-owned businesses.
 - Among traditional banks, PPP loan shares to Black-owned businesses increased with bank size, ranging from 3.3% at small banks (the banks with the least automated systems) to 6.2% at the largest banks.

⁵ <https://libertystreeteconomics.newyorkfed.org/2021/05/who-received-ppp-loans-by-fintech-lenders.html>

⁶ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3939384

- Overall, fintech lenders were responsible for 53.6% of PPP loans to Black-owned businesses, while only accounting for 17.4% of all PPP loans.

The Cares Act which authorized the PPP was signed into law on March 27, 2020. It mandated that the PPP be implemented within 15 days. By August there were 5.2 million approved loans, totaling \$525 billion. As everyone involved in the program knows, speed became the highest priority with the SBA tasking lenders to rely on borrower self-certifications in order to get funding to businesses as quickly as possible. Unfortunately, the PPP along with a host of other government funded pandemic era programs experienced unprecedented levels of fraud, with investigators still working to identify its full extent. While there is still a lot we don't know about the actual fraud in the program, we do know that according to the SBA Inspector General⁷:

- SBA did not provide lenders sufficient specific guidance to effectively identify, track, address, and resolve potentially fraudulent PPP loans
- lenders were not always clear on how to handle PPP fraud or recover funds obtained fraudulently from the PPP that remained in the borrower's account
- control gaps weakened SBA's ability to actively prevent and reduce fraud and increased the risk of fraudulent and ineligible applicants receiving PPP loans and loan forgiveness
- SBA did not have an organizational structure with clearly defined roles, responsibilities, and processes to manage and handle potentially fraudulent PPP loans across the program
- SBA did not establish a centralized entity to design, lead, and manage fraud risk
- SBA did not establish a sufficient fraud risk framework at the start of and throughout PPP implementation

We know that the PPP, in its design to optimize for speed, had serious program deficiencies that allowed fraud to occur including changes made in February and March of 2021 which likely dramatically increased fraud among Schedule C filers, entities in which banks largely avoided or ignored. It is also important to note that the fraud that resulted from the PPP program does not have far reaching implications for banks or fintechs beyond the PPP because the design of and circumstances surrounding the program are unlike any private or public lending program.

⁷ <https://www.sba.gov/sites/default/files/2022-05/SBA%20OIG%20Report%202022-13.pdf>

Fintech and SBA 7(a) Program

Nearly 70 years after the Small Business Act established the 7(a) program, small businesses continue to struggle to receive adequate and equal access to capital. The 7(a) program has relied largely on state and national chartered banks to extend 7(a) loans but their balance sheets year after year show little interest in serving small businesses, especially smaller dollar loans (<\$150,000) that are most needed in low-moderate income areas. Fortunately, non-bank state-regulated fintech lenders are able to fill the gap by getting loans to underserved communities across the country just like they did in PPP. However, in order for non-federally regulated lenders (NFRL) to offer 7(a) loans nationwide, they need to obtain a Small Business Lending Company (SBLC) license. Unfortunately, the SBA implemented a moratorium on granting new licenses in 1982 limiting the total number of licenses issued to 14.

Considering the SBA fell short of its FY19 goal of loans to socially and economically disadvantaged areas by 23%, the shrinking bank balance sheets consisting of small business loans, and the current unprecedented economic crisis our nation's small businesses are experiencing due to the COVID-19 virus and economic recession, the SBA should be working to modernize its program by leveraging fintech lenders to reach the more than 50% of small businesses whose capital needs are unmet by the market today.

SBA has stated it "does not have the administrative resources needed to oversee NFRLs with a nationwide 7(a) lending platform in addition to the 14 SBLCs it currently regulates" and that the agency "encourages [these lenders] to acquire one of the fourteen SBLC licenses that become available from time to time" which costs millions of dollars. Essentially, the SBA has created the taxi cab medallion of government guaranteed lending licenses and in the process continued to choke off or limit access to capital, the biggest issue it was tasked to help solve by Congress.

SBA can remove the moratorium on its own which ILPA encourages it to do but should the agency refuse, Congress should rescind the moratorium by passing the Expanding Access to Credit for Small Business Act which gives the agency additional resources it says it needs to supervise additional SBLC and strengthens the program by implementing a higher set of BSA/AML requirements.

ILPA urges policymakers to remain thoughtful and forward-thinking in how to best support industry's on-going efforts to provide opportunities for all small businesses to access responsible, affordable capital. Efforts by policymakers to regulate commercial financial products and services should be done collaboratively with industry participants and with careful consideration of the many types of business models and products in the marketplace. ILPA stands willing to work with the Subcommittee and other interested parties to refine these proposals and to create a positive legislative environment.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott Stewart". The signature is fluid and cursive, with the first name "Scott" and last name "Stewart" clearly distinguishable.

Scott Stewart
CEO, Innovative Lending Platform Association

Congress of the United States
Washington, DC 20515

July 29, 2021

Dave Uejio
Acting Director
Consumer Financial Protection Bureau
1700 G St NW
Washington, D.C. 20552

We write to you today regarding Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 1071). In February of this year you issued a memo to the CFPB Division of Research, Markets, and Regulations (RMR), where you “pledged RMR the support it needs to implement section 1071 without delay.”¹ In addition, on June 11 the CFPB published its Spring 2021 Rulemaking Agenda that included section 1071 with a tentative deadline for a Notice of Proposed Rulemaking (NPRM) in September of this year.² As the CFPB continues in the rulemaking process, we urge you to build on the efforts of the previous Director, specifically the Small Business Advocacy Review (SBAR) panel conducted under Director Kraninger and required by the Small Business Regulatory Enforcement Fairness Act (SBREFA).

Section 1071 amended the Equal Credit Opportunity Act (ECOA) to require financial institutions to compile, maintain, and submit certain data to the CFPB on women owned, minority owned, and small businesses. As you know, SBREFA requires certain federal agencies, including the CFPB, to conduct a SBAR before publishing a proposed rule that includes a Regulatory Flexibility Analysis. The SBAR conducted regarding Section 1071 includes representatives from the CFPB, Small Business Administration (SBA), and the Office of Information and Regulatory Affairs (OIRA). The panel held numerous outreach meetings with Small Entity Representatives (SERs) to solicit feedback on how a potential 1071 rulemaking will impact small firms and potential regulatory solutions to ease regulatory burdens, eliminate duplicative reporting, streamline data reporting, and narrow the scope of 1071 applicability.

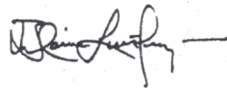
Considering only three government entities are required to conduct additional outreach to small entities through a SBAR panel, including the CFPB, it is evident the broad range of regulatory authority exhibited by the Bureau has a considerable impact on small businesses. It is critical the CFPB consider the numerous findings of the SBAR and closely follow the recommendations of the panel to eliminate burdens, decrease duplication, and take into account the feedback of SERs when developing a Notice of Proposed Rulemaking. Specifically, we urge you to consider the potential for increased regulatory costs on financial institutions and the potential impact on access to capital for all small businesses.

¹ <https://www.consumerfinance.gov/about-us/blog/the-bureau-is-working-hard-to-address-housing-insecurity-promote-racial-equity-and-protect-small-businesses-access-to-credit/>

² <https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3170-AA09>

When SBREFA was enacted in 1996, Congress intended to enhance and improve the ability of federal agencies to thoroughly understand how their rules impact small firms and concordantly use that information to eliminate unnecessary burdens on those entities. Over time, the SBREFA process has been treated as merely a check-the-box initiative where outreach is made to SERs, but their feedback is not adopted in the final rulemaking. We will closely monitor any NPRM from the Bureau regarding Section 1071 and will expect to see provisions responding to the numerous concerns voiced by SERs in the SBAR, and an overall rule that strives to limit burdens on small entities.

Sincerely,



Blaine Luetkemeyer (MO-3)
Member of Congress



Roger Williams (TX-25)
Member of Congress



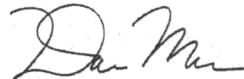
Bill Posey (FL-08)
Member of Congress



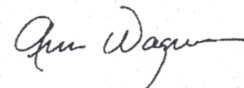
Pete Stauber (MN-8)
Member of Congress



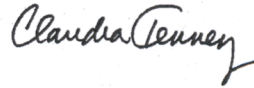
Bill Huizenga (MI-02)
Member of Congress



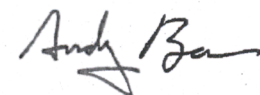
Dan Meuser (PA-9)
Member of Congress



Ann Wagner (MO-02)
Member of Congress



Claudia Tenney (NY-22)
Member of Congress



Andy Barr (KY-06)
Member of Congress



Andrew Garbarino (NY-2)
Member of Congress



French Hill (AR-02)
Member of Congress



Young Kim (CA-39)
Member of Congress



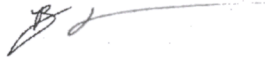
Tom Emmer (MN-06)
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Beth Van Duyne (TX-24)
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Lee M. Zeldin (NY-01)
Member of Congress



Byron Donalds (FL-19)
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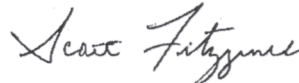
Barry Loudermilk (GA-11)
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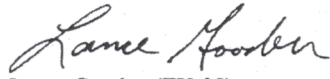
David Kustoff (TN-08)
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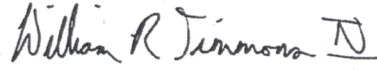
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National Association of Federally-Insured Credit Unions

July 12, 2022

The Honorable Dean Phillips
Chairman
Subcommittee on Oversight,
Investigations, and Regulations
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

The Honorable Beth Van Duyne
Ranking Member
Subcommittee on Oversight,
Investigations, and Regulations
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

RE: Tomorrow's Hearing, "Fintech and Transparency in Small Business Lending"

Dear Chairman Phillips and Ranking Member Van Duyne:

I write today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU) in conjunction with tomorrow's hearing regarding the effect of innovations in financial technology and online lending on small businesses. As you are aware, NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 131 million consumers with personal and small business financial service products. As your Subcommittee examines the growing role that technology companies play in small business lending, we urge you to examine their presence in the market for financial services and the risks they could pose to consumers, small businesses, and the financial system.

The growth of fintech in recent years offers new opportunities for the delivery of financial services. The use of financial technology can have a positive effect on credit union members. Credit unions have worked with fintech companies to improve efficiency in traditional banking, and many of the technologies that are commonplace today, such as credit cards and e-sign, would have once qualified as "fintech" when they were first introduced. Consumers today have come to expect technological developments from their financial institution—from online banking to mobile bill pay. Many credit unions embrace innovations in technology to improve relationships with members and offer more convenient and faster access to financial products and services.

However, the growth of fintech can also present new threats and challenges as novel entities emerge in an underregulated environment. As such, NAFCU believes that Congress and regulators must ensure that when technology firms and fintechs compete with regulated financial institutions, they do so on a level playing field where smart regulations and consumer protections apply to all participants. NAFCU has outlined some of the challenges and opportunities in this area in a [white paper](#) that proposes regulatory recommendations for oversight of fintech companies operating in the financial services realm.

Credit unions look forward to continuing to experience growth in the technology space as a way to better serve their members, including small businesses. However, as technology companies expand, and new charters emerge to compete in the financial services marketplace, it is important that they compete on a level playing field of regulation and supervision—whether lending to consumers or small businesses. It

is important that Congress ensures laws are modernized to protect consumers and small businesses and to ensure credit unions are able keep up and compete with technological advances.

Thank you for your attention, and we look forward to working with you on these important issues. Should you have any questions or require additional information, please do not hesitate to contact me or Chad Adams, NAFCU's Senior Director of Legislative Affairs, at (703) 842-2265 or cadams@nafcu.org.

Sincerely,

A handwritten signature in black ink, reading "Brad Thaler". The signature is written in a cursive, flowing style.

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Subcommittee on Oversight, Investigations, and Regulations



TESTIMONY OF
LENWOOD V. LONG, SR.
President and CEO
African American Alliance of CDFI CEOs

REGARDING
“Fintech and Transparency in Small Business Lending:

BEFORE THE
COMMITTEE ON SMALL BUSINESS SUBCOMMITTEE ON OVERSIGHT,
INVESTIGATIONS, AND REGULATIONS

UNITES STATE HOUSE OF REPRESENTATIVES

JULY 20, 2022

Chairman Phillips, Ranking Member Van Duyne and distinguished members of House Small Business Subcommittee on Oversight, Investigations, and Regulations Subcommittee, my name is Lenwood V. Long, Sr., President and CEO of the African American Alliance of CDFI CEOs (“the Alliance”). The Alliance is a membership-driven intermediary organization of over 60 Black-led CDFIs that aims to: build the capacity of member organizations; build bridges to economic stability, well-being, and wealth for Black individuals, families, and communities; and build power in Black communities by challenging and influencing financial sectors to operate more equitably. As advocates for public policy and support for underserved communities, we are uniquely positioned to understand and engage the communities we serve.

Mr. Chairman and Ranking Member, I would like to thank you and the subcommittee for your commitment to ensuring fair and transparent fintech industry practices that protect our entrepreneurs as they pursue critical capital for their small businesses.

As we all know, minority-owned businesses are critical to job creation and preservation in chronically underserved communities. In fact, more than 2.2 million jobs are held by persons who find themselves either directly or indirectly employed by National Minority Supplier Development Council-certified Minority Business Enterprises (MBEs). It is often difficult for many minority-owned businesses to expand and grow due to lack of financing. The 2021 Small Business Credit Survey found that Black-owned firms that applied for traditional forms of financing were least likely to receive all the financing they sought – 40 percent of white-owned firms received all the financing they sought, compared to 31 percent of Asian-owned firms, 20 percent of Hispanic-owned, and only 13 percent of Black-owned firms. This trend persists even amongst firms with comparable good credit scores. Often, Black businesses will rely on financing from alternative institutions such as minority-led CDFIs or MDIs. These institutions, which lend to Black communities at a greater rate than that of white-led and traditional financial institutions, specialize in lending to individuals, organization, and businesses in under-resourced communities. As evidence, research conducted by the Association Enterprise Opportunity showed that the wealth gap between Black and white business owners (3:1) is significantly lower than the overall Black/white wealth gap (13:1), a testament to the effectiveness of these minority-led institutions in reaching undercapitalized communities of color.

A more recent development has been the rise of financial technology (fintech) lending in the minority-owned small business space. A major reason for fintech’s late success is that they, relative to traditional banks, CDFIs and MDIs, are arguably better equipped to make quick decisions regarding customer creditworthiness and offer a more seamless and efficient customer experience. Despite fintech’s role in expanding access to credit for small business, these firms present unique challenges for prospective borrowers. For instance, many fintech lenders provide borrowers with scant information about promoted loan products, often omitting critical information regarding rates, fees, and repayment schedules. Ambiguous or opaque product

descriptions makes it extremely difficult for borrowers to accurately access the cost of a particular fintech product offering, thus leaving borrowers vulnerable to irresponsible lenders. Further, some fintech lenders promote predatory repayment methods, such as Merchant Cash Advances (MCA). MCAs allow the fintech lender to receive a fixed percentage of future sales until the loan is repaid; however, MCAs are often accompanied by high APRs and daily repayments, resulting in an unmanageable debt cycle for the small business owner. In the most unfortunate cases, these repayment mechanisms can result in the closure of the small business. To that end, the Alliance would support efforts to extend the federal Truth in Lending Act (TILA) APR disclosure requirement to small business owners who apply for loans and financial credit products. Finally, fintech underwriting lacks the level of transparency exercised by traditional banks, CDFIs and MDIs. Specifically, information collected by fintech lenders in underwriting small business loans could be based on race or gender, characteristics protected by fair lending laws. In turn, this could lead to small business applicants being unfairly denied or offered products at a higher APR.

Mr. Chairman and Ranking Member, I thank you for this opportunity to provide written testimony on this important topic. The Alliance believes that small businesses are America's backbone, employing nearly half of all employees and accounting for 44 percent of economic activity in the U.S. The Alliance believes that fintech can be a positive force in expanding access to capital to small business owners who have long been excluded from or marginalized in our capital markets. However, it is imperative that the continued growth of this promising, yet nascent, industry is not stymied by a few bad actors that utilize exploitative methods to take advantage of unsuspecting entrepreneurs. Rather, there should be a commitment to making fintech a safe, predictable, and cost-effective means of finance for our nation's entrepreneurs. We look forward to working with you in meeting that goal.



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US House Committee on Small Business

Fintech and Transparency in Small Business Lending

**Testimony by: Regina A. Hairston, President & CEO of the African American
Chamber of Commerce of Pennsylvania, New Jersey, and Delaware**

My name is Regina A. Hairston, President & CEO of the African American Chamber of Commerce of Pennsylvania, New Jersey, and Delaware ("AACC") where over 152,000 Black-owned businesses reside. Today, I am offering written testimony on Fintech and transparency in small business lending.

As the leading advocate for Black-owned businesses in the region, our purpose at the Chamber is to enhance the growth and effectiveness of local businesses and improve the economic conditions of the Black community.

For many Black entrepreneurs, access to affordable capital is a significant obstacle in starting their business. This is an issue we have tried to address at the African American Chamber of Commerce through initiatives such as the Coaching to Capital Program, which provides members with one-on-one business consulting, mentors, and training to prepare them to access the commercial lending market.

Although we have educational initiatives for our members, the fact persists that Black-owned businesses have a significantly harder time gaining access to competitive loans in comparison to their white counterparts. According to a national survey [from August of 2020](#), twenty-three percent of Black business owners who did not receive PPP or Economic Injury Disaster Loans said that their application loans were denied, compared to only 9 percent of white business owners, 13 percent of Hispanic businesses owners, and 9 percent of Asian American business owners.

There are many challenges that up-and-coming businesses, particularly Black businesses, face. Fintech has the potential to remove barriers and provide benefits to small businesses struggling to receive financing through traditional means. However, there are questions about the transparency and equality of the process that remain to be addressed.

One of the many reasons that Black-owned businesses have a difficult time receiving competitive interest rate loans is due to the disproportionately higher interest rates that they are subject to from the start of their entrepreneurial journey. These increased rates make Black businesses less “attractive” in the eyes of lenders due to higher risk and lower reward in terms of return on investment. This is because of the higher amount spent on interest and subsequently lower profit margins which makes starting, growing, and expanding the business significantly more difficult and often impossible due to disparities in access to affordable and competitive capital.

The above practices are inherently inequitable and obscure, but not uncommon in the lending market. As we have heard in the hearing, Fintech and online loans can have a much higher APR percentage than traditional bank loans, despite the faster approval process. This can lead to a much more substantial cost for businesses and raises questions about predatory lending practices which have historically harmed Black-owned businesses and have the potential to trap small businesses in a cycle of debt.

This cycle of debt has been further exacerbated by the current inflation crisis across the United States. To further expand, ordering in bulk during inflationary periods generally means a lower cost per item; however, ordering in bulk also means a higher up-front cost. This cost is not easily manageable and often requires debt capital i.e., loans for products to be procured. Unfortunately, this circles back to predatory lending practices because working capital comes at an unduly higher cost for Black businesses and places them in a position of exploitation by financial lenders.

As a reminder, the above are only a portion of the challenges that Black-owned businesses encounter. Other notable issues pertaining to Fintech transparency in Black-owned businesses include:

- Inability to acquire federal contracts because they are “lowest bid” - which makes it hard to compete if debt and working capital cost more.

- Hard to update systems, technology, and processes that are not reflective of the evolution of current lending capabilities.
- Pandemics and emergencies are disastrous for Black-owned businesses that have fewer capital, assets, reserves, and access to lines of credit.

We at the African American Chamber of Commerce support measures that could help benefit and prioritize Black businesses. As Fintech continues to grow and evolve, we need to ensure that the process through which small businesses obtain loans is transparent, equitable, and inclusive.

Thank you for your time and consideration.

Regina A. Hairston



Statement Submitted by
 Alison Feighan on behalf of
 The Responsible Business Lending Coalition

to the
 U.S. House Committee on Small Business
 Subcommittee on Oversight, Investigations and Regulations
 for the July 13, 2022, hearing entitled
 “Fintech and Transparency in Small Business Lending”

Chairman Phillips and Ranking Member Van Dyne, the [Responsible Business Lending Coalition \(RBLC\)](#)¹ appreciates the opportunity to submit this statement for the record in response to the Subcommittee’s hearing, “Fintech and Transparency in Small Business Lending,” and some of the questions discussed during the hearing.

As the foremost cross-sector voice advocating for small business financial protection, the RBLC’s leadership includes nonprofit and for-profit fintech lenders, community development financial institutions, investors, and small business advocates. Members of the RBLC share a commitment to innovation in small business lending as well as serious concerns about the rise of irresponsible small business financing.

The Value of Transparency

We believe that the lack of transparency in small business financing is undermining market competition, stymying innovation, and misleading small business into paying unnecessarily high rates. For many small businesses, choosing an unaffordable credit product unknowingly could be the difference between survival and failure.

Small businesses owners are not protected by the Truth in Lending Act which requires the transparent disclosure of annual percentage rates (APR) in consumer lending. In this regulatory gap, the small business credit marketplace has evolved and grown significantly in recent years, with providers expanding access to capital for entrepreneurs while simultaneously increasing the complexity of products offered to business borrowers. The RBLC believes that innovation must be met with responsible lending standards to ensure that small businesses are treated fairly and can make informed decisions.

To this end, in 2015, the RBLC authored the Small Business Borrowers’ Bill of Rights (BBorR)

¹ Members of the RBLC include Accion Opportunity Fund, Camino Financial, Community Investment Management, Funding Circle, LendingClub, National Association for Latino Community Asset Builders, Opportunity Finance Network, Small Business Majority, and the Aspen Institute.

detailing the fundamental financing rights that all small businesses deserve, and the practices that lenders must abide by to uphold those rights. The BBoR includes the Right to Transparent Pricing and Terms, which calls for small business financing providers to clearly disclose seven key elements to businesses applying for credit:

1. Loan amount, and total amount provided after deducting fees or charges
2. Annual percentage rate (APR) or estimated APR
3. Payment amount and frequency, including the actual or estimated total payment amount per month if payment frequency is other than monthly
4. Term or estimated term
5. All upfront and scheduled charges
6. Collateral requirements
7. Any prepayment charges

The Need for Universal APR Disclosure

Disclosure of these key terms, particularly the APR or estimated APR, is critical to help small businesses compare different financing products and make informed decisions. APR is the only metric that enables apples-to-apples comparisons of products with different fees, interest, and term lengths over a common unit of time. Paying \$10,000 to rent an apartment for a month is not the same as paying \$10,000 to rent for a year. The same is true in financing, which is the rent of money over a period of time. Without APR, a prospective borrower could not quickly compare the cost of borrowing \$10,000, for example, using a five-year term loan with a 15% interest rate and \$1,000 origination fee, to a 12-month cash advance with a 4% fee rate, to a credit card with a 24.9% interest rate.

Some financing companies that charge high APRs have argued that the dollar total of fees and interest charged is sufficient for small businesses to understand pricing. However, a business cannot easily compare the cost of products with different repayment durations (e.g. a 12-month cash advance compared to a five-year loan) using total cost of capital alone. Too often, small business financing providers not only fail to provide an APR but also disclose different, so-called “rates,” such as a “fee rate” or “simple interest rate” that are lower than the actual interest rate or APR and lead small businesses to underestimate the cost of certain products.

The Federal Reserve Board and Federal Reserve Bank of Cleveland conducted an in-depth study of small businesses’ experiences with alternative, online lenders offering a variety of products including lines of credit, merchant cash advances (MCA), and loans.² In the study,

² Federal Reserve Board, “Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites,” 2019, <https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf>

researchers presented small business owners with disclosures for different financing products currently available to small businesses. Researchers found that “non-standard terminology” used by some alternative lenders “proved challenging for focus group participants trying to compare online offerings with traditional credit products.”³ They provided the small businesses with a sample product – “a \$50,000 MCA with a factor rate of 1.2 and total repayment of \$60,000” – and asked participants to guess the equivalent interest rate. Participants all received exactly the same information but “responded with a wide range of estimates.”⁴ The true APR was roughly 40%.

The Federal Reserve’s research clearly demonstrates that many business owners do not understand the disclosures currently provided by some financing companies. The table below, from the Federal Reserve’s research, shows how easy it is to misunderstand the “non-standard” information presented by some financing companies.

Table from the Federal Reserve’s “Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites” (p. 18)

Table 3. Estimated APRs for select online products		
Rate advertised on website	Product details	Estimated APR equivalent
1.15 factor rate	• Total repayment amount \$59,000 • Fees: 2.5% set-up fee; \$50/month administrative fee • Term: none (assume repaid in six months) • Daily payments (assume steady payments five days/week)	Approximately 70% APR
4% fee rate	• Total repayment amount \$56,500 • Fee rate: 4% (months 1–2), 1.25% (months 3–6) • Fees: none • Monthly payments • Term: six-month term	Approximately 45% APR
9% simple interest	• Total repayment amount \$54,500 • Fees: 3% origination fee • Weekly payments • Term: six-month term	Approximately 46% APR

Source: Authors’ calculations, based on product descriptions on company websites.

³ Ibid.

⁴ Ibid.

Without a clear understanding of the terms presented to them, small businesses risk taking out higher-cost debt that may prove to be unaffordable, under the false assumption that it will be less expensive than other available options.

The Federal Reserve research demonstrated that a small business is likely to assume that it will be less costly to cover an unexpected expense with an MCA charging a 1.15% factor rate, as shown in the example above, than to use a credit card with a 30% APR. However, as the table above shows, the credit card's 30% APR is far lower than the MCA's 70% APR. It is important to note that small businesses are often deciding between funding their business with commercial financing products or a consumer product that is quoted in terms of APR. In addition to credit cards, businesses often use personal loans, auto loans, and home equity lines of credit alongside commercial financing like merchant cash advances.

As the right-hand column above illuminates, APR disclosure for all types of financing would give small businesses a common language with which to compare the cost of differently-structured products. In order to achieve full transparency and ensure that businesses can easily compare offers, APR must be disclosed for various types of financing, as well as for products with terms less than one year. While some claim that disclosure of an annualized rate is generally inappropriate for terms under one year, in the context of small business financing, short-term products are frequently renewed or refinanced to expand the initial repayment amount and duration. One provider states: "Approximately 90% of our Merchant Cash Advance clients participate in the program more than once. In fact, the average customer renews about ten times!"⁵ Therefore, a product that begins with an expected term under one-year will likely extend beyond this period after renewals are accounted for, so APR disclosure upfront would be reasonable and useful to small businesses considering shorter-term financing.

The financing companies using misleading rates could transparently inform small businesses of the APR, but may fear that if small businesses were informed of the high APRs they would be charged, some of those businesses would instead seek more affordable financing. In essence, instead of the market exhibiting healthy price competition and driving prices down, some financing companies are unfairly profiting off of their customers' lack of information.

Impact of Undisclosed High APRs on Small Business Borrowers

Accion Opportunity Fund (formerly Opportunity Fund) conducted an analysis on the impact of high-cost loans on small businesses.⁶ They analyzed the business cash flow and loan terms of 104 small businesses that had taken out alternative loans, finding that businesses had been charged average APRs of 94%, and as high as 358%, without those APRs having been

⁵ Rapid Advance, "RapidAdvance Merchant Cash Advance Program," 2016.

⁶ Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," 2016. https://www.opportunityfund.org/wp-content/uploads/2019/09/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

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

disclosed to the borrowers. The high APRs also proved to be unaffordable. Analysts found that average monthly loan payments were nearly double the small business' net income available for debt payments. The report noted that "this unsustainable ratio severely hampers an owner's ability to expand a business or hire new employees, and drastically undermines the long-term viability of an enterprise."

RBLC members too often hear from small business owners who have taken out costly debt from alternative lenders, with terms that were not presented clearly upfront, seeking to refinance the debt into a lower-cost product with affordable payments. Responsible lenders do all they can to bring relief to these businesses and prevent high payments from putting the business at risk. Sometimes lenders are able to refinance the debt and sometimes it is too late. In an attempt to keep up with unaffordable payment obligations, some businesses take out additional high-cost debt and use new loan proceeds to repay the original loan. With some financing providers encouraging small businesses to take on new loans that the business cannot truly afford, businesses can quickly get caught in debt traps that have the potential to drain all of the business' resources and force them to shut down.

Why APR is Critical and Applicable

Higher-cost lenders express support for transparency in principle but oppose disclosure of the most critical metric, APR, that small businesses told the Federal Reserve would be helpful for understanding and comparing different financing products.⁷ In direct opposition to the Fed's research findings on small business lending disclosures, high-cost cash advance and similar providers claim that APR disclosure would confuse, rather than inform borrowers. However, the Federal Reserve found that borrowers are currently confused by the "non-standard terminology" that APR opponents use to describe and market their products.⁸ The Fed notes that for small business borrowers like those included in their study, "determining the equivalent APR on some products may be challenging" because non-standard metrics used by alternative, high-cost providers are not well understood.

Opponents also claim that estimated APR for sales-based products would be difficult to calculate and unhelpful to borrowers. For cash advances or other products that are repaid as a percentage of daily or weekly sales, there is no set repayment term (e.g. 12 months). Borrowers pay their lender a set percentage of their revenue (e.g. 20% of receipts) until the loan and fees are repaid in full. Sales-based providers must estimate the time it will take businesses to repay in order to determine the expected term duration and estimate an APR. Fortunately, these providers already

⁷ Federal Reserve Board, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019.

<https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-whenbrowsing-online-lender-websites.pdf>

⁸ Ibid.

collect their small business borrowers' historical sales volumes during the application process and could use this information to calculate expected time to repayment. Sales-based financing companies already project annualized rates for their investors. They can easily disclose these (often high) rates to their customers but may prefer not to.

Providing an APR estimate, quoted to borrowers as such, would give small businesses a clearer understanding of loan pricing than the "non-standard" metrics currently disclosed. Without estimated APR, product descriptions that the Fed has found to cause significant confusion would continue to include unclear metrics that are not comparable to other loan offers the business may be considering. Small businesses need universal APR or estimated APR disclosure for all products in order to make informed decisions.

The RBLC believes that laws work best when they are clear in their intent, easy to understand, to comply with, and to enforce. To that end, we urge members of the subcommittee to support the Small Business Lending Disclosure Act (H.R. 6054) as introduced by Chairwoman Nydia Velazquez.

The Small Business Lending Disclosure Act would bring much needed transparency to small business credit markets.

Without standardization of disclosure requirements across lenders, small businesses are more likely to choose higher-cost products. Research indicates that small businesses can pay APRs of 94%, and as high as 350%, without these high rates being properly and clearly disclosed.⁹ What's more, a Federal Reserve study demonstrated that Black- and Hispanic-owned businesses are more likely to use "high-cost" and "non-transparent" financing, referring specifically to merchant cash advances as well as factoring products.¹⁰

APR is the only established metric that enables informed comparisons of the cost of capital over time and between products of different dollar amounts and term lengths. APR is the time-tested rate that people know and expect because it is the legally required standard for mortgages, auto loans, credit cards, student loans and personal loans, including short-term loans.

We are honored to serve as a resource to you and your staff if you have questions or would like additional information.

⁹ Opportunity Fund, 2016.

¹⁰ Federal Reserve Board, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019:
<https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf>

Signed,
The Responsible Business Lending Coalition



Note: The RBLC would like to correct a statement made during the hearing regarding LendingClub's small business lending program. LendingClub has a maximum APR of 25%, inclusive of both fees and interest expenses. Their online small business lending program is designed to serve small businesses who are underserved by traditional banks, and is operated as a fintech/CDFI partnership with the Accion Opportunity Fund CDFI. This partnership was the focus of a chapter in the Federal Reserve Bank of San Francisco's publication titled "Fintech, Racial Equity, and an Inclusive Financial System."¹¹ Over half of the loans in this program have gone to minority-owned businesses. LendingClub also offers low-cost SBA 7(a) and 504 loans, and commercial real estate loans, which are among the lowest-cost options for many small businesses and offered with transparent disclosure of APRs.

¹¹ Federal Reserve Bank of San Francisco, "Fintech, Racial Equity, and an Inclusive Financial System," 2021. <https://www.frbsf.org/wp-content/uploads/sites/3/fintech-racial-equity-inclusive-financial-system.pdf>

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