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to invest in their business, purchase inventory, hire additional employees, expand the business, and repair damaged or outdated equipment.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 Reserve[1] fintech lenders:

- now disproportionately provide more access to credit to underserved communities than traditional financial institutions[2]

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[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 2021[3].

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/medialibrary/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 even[4]. 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

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[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 research[5] 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 lending[6]. 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.

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[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 General[7]:

- 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%2022-13.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,

Scott Stewart
CEO, Innovative Lending Platform Association