CFPB Symposium on Section 1071 of the Dodd-Frank Act
Panel 1: The Current and Future Outlook for the Small Business Lending Marketplace

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Executive Summary

The implementation of Section 1071 of the Dodd-Frank Act (Section 1071) is critical to understanding the credit needs and financing outcomes of small business owners in today's small business lending marketplace—particularly for minority and women entrepreneurs. At Opportunity Fund, we see firsthand both the meaningful contributions that these business owners make to their local communities and the economy, as well as the challenges they face in accessing responsible and affordable capital in an evolving marketplace. Thorough data collection of small business financing can benefit all stakeholders—industry, regulators and, ultimately, American small business owners.

About Opportunity Fund

Opportunity Fund is a non-profit financial institution founded in 1994 that drives economic mobility by delivering affordable capital and responsible financial solutions to determined entrepreneurs and communities. A nationally recognized leader among Community Development Financial Institutions (CDFIs), Opportunity Fund is the largest nonprofit microlender in the U.S. by portfolio size. We achieve our mission by providing micro and small business loans from $2,600-$250,000, with a particular focus on low and moderate-income entrepreneurs, minority and women-owned businesses across 45 states.

Approximately 62% of Opportunity Fund's microloan clients are of low- to-moderate income; 86% are ethnic minorities, and 32% are women.[1] These clients have an average credit score of 679, with approximately 7% having no credit history at all. Our loans provide disadvantaged entrepreneurs with access to credit to grow a business; support themselves and their families; create and retain jobs, and generate economic activity in their communities.

[1] Opportunity Fund: "The State of Small Business," 2019.

Emerging Trends in Small Business Financing

Defining Small Business Financing

Opportunity Fund makes business loans up to $250,000, and we consider all of the businesses we serve to be subject to Section 1071 reporting requirements. The businesses we serve would traditionally be considered “small” based on revenue (averaging $350,000 per business) and number of employees (averaging 2-3 per business). We believe that “small business non-equity financing” should be defined as financing below $1 million, exempting financing to larger firms. Loan size of $1 million is an existing threshold used by the Federal Financial Institutions Examination Council in CRA reporting. We consider “small business financing” to include all types of capital provided to small businesses, including but not limited to term loans, lines of credit, supplier financing, equipment leasing, business credit cards, SBA and microloans, factoring and merchant cash advances (MCA).

Minority and Immigrant Businesses are Driving the Economy

Entrepreneurship is the celebrated emblem of American grit, ingenuity, and self-made success. It is also an economic powerhouse, as fundamental to maintaining Wall Street as it is to sustaining Main Street. According to the Small Business Administration, small businesses generate 44% of U.S. economic activity.[2] In addition, they employ 49% of the American workforce and generate 64% of net new private sector jobs.

Opportunity Fund believes that the extent to which women, minorities and immigrants propel entrepreneurship is frequently overlooked. While 13% of the U.S. population was born outside the country, immigrants represent 28% of the country’s Main Street entrepreneurs.[3] And yet, these days, immigrants are often vilified, and entrepreneurship is declining.[4]

Even though American entrepreneurship is on the decline, immigrants are twice as likely to start a business as native-born Americans.[5] Additionally, the rate of new women-owned businesses

[2] U.S. Small Business Administration, Office of Advocacy: “Small Business GDP, 1998-2014,” 2018.
[3] America Society, Council of the Americas: “Bringing Vitality to Main Street: How Immigrant Small Businesses Help Local Economies Grow,” 2015.
[4] The New York Times: “A Start-Up Slump Is a Drag on the Economy. Big Business May Be to Blame,” 2017.
[5] Harvard Business Review: “Why Are Immigrants More Entrepreneurial?,” 2016.

has increased by 15.4 percent since 2016.[6] When looking at who is starting businesses at the highest rate, one in four new businesses is owned by a Latino owner.[7]

At Opportunity Fund, we see the significant contributions that low-moderate income, women, and minority-owned businesses make to our society. The implementation of Section 1071 will help us catapult their successes by providing better financing products that meet their needs and allow their businesses to thrive.

Challenges Small Business Owners Face In Accessing Credit

At Opportunity Fund we see daily evidence that successful, credit-worthy small businesses cannot obtain responsible, affordable capital in the private sector. These small business owners face barriers to obtaining credit from banks and other mainstream financial institutions, including online and fintech lenders. These obstacles include limited cash reserves and collateral, low capital needs, subprime credit scores, limited financial education, and/or a short history of business operation. These issues are accentuated for women and minority owned small businesses operating in low and moderate income communities, due to structural disadvantages in wealth distribution and education levels. All of these factors combined make accessing a traditional bank loan very difficult.

As one of our borrowers, Adena Brandt, of Living Air Ware stated, “As a small business working with independent CPAs, it has been common procedure to treat all of my startup costs as operating expenses which puts my operating revenue in the red at year's end. I didn't know any better the first year but on the second [sic] I had to go through a half dozen CPAs before finding one that understood the problem. I made big steps in correcting the misallocations, but it takes time for everything to fall into place. In the meantime, I'm reporting zero income to the IRS, which makes it so lenders won't touch me. My credit score is greater than 750 but I can't get credit/capital to fund my business because of the lack of income. But I'm making money and paying down past debts without a problem. It's incredibly frustrating.”

For minority-owned businesses and businesses focused on serving ethnic-minority communities, cultural misunderstanding between traditional financial institutions and the products/services offered by the business present an additional challenge. As another borrower stated, “Some minority-owned businesses I work with offer ethnic products and services to

[6] Ewing Marion Kauffman Foundation: “State of Entrepreneurship,” 2019
[7] Federal Reserve Banks: “Latino-Owned Businesses: Shining a Light on National Trends,” 2018.

markets that are not understood by the traditional lending establishments. These businesses may have difficulty convincing lenders that a strong revenue case exists for their products & services."

Research done more widely on the factors affecting credit accessibility confirm these stories. The Federal Reserve's 2016 Small Business Survey found microbusinesses were less likely to have collateral, less likely to receive the full amount of financing they applied for, and more likely to apply for a MCA or online loan.[8] A paper from The Brookings Institution noted that minority- and women-headed households generally have lower levels of household wealth, making external borrowing more difficult.[9] Similarly, according to the U.S. Department of Commerce, Minority Business Development Agency, minority-owned businesses are less likely to receive loans, more likely to receive lower loan amounts and more likely to be denied loans when compared to non-minority businesses.[10]

Particularly since the Great Recession when bank lending to small businesses declined by 18%, conventional credit sources are typically out of reach for the majority of small business owners, particularly for women and minorities.[11] The exit of banks from the small business lending marketplace created opportunities for new players and products to fill the gaps and provide financial capital to small business owners. As such, the small business lending marketplace has changed drastically over the last five to 10 years.

Changes and Challenges in the Evolving SB Financing Marketplace

At Opportunity Fund, located in the heart of Silicon Valley, we have seen firsthand the emergence of fintech and alternative lenders. They have transformed the marketplace, with the most significant impact and changes relating to the speed of providing capital, pricing, and transparency. Many traditional banks have felt the pressure to improve their technological capabilities and customer experience to keep up with market expectations. However, due to cumbersome legacy systems and the lack of engineering skills, banks have chosen to outsource

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[8] Federal Reserve Banks: "2016 Small Business Credit Survey: Report on Microbusiness," 2017.
[9] The Brookings Institute, The Hamilton Project: "Minority and Women Entrepreneurs: Building Capital, Networks, and Skills," 2015.
[10] U.S. Department of Commerce, Minority Business Development Agency: "Disparities in Capital Access Between Minority and Non-Minority Businesses," 2010.
[11] U.S. Small Business Administration, Office of Advocacy: "How Did Bank Lending to Small Business in the United States Fare After the Financial Crisis?," 2018.

their lending to fintech companies, such as Fundation and SmartBiz who can provide a White Label solution.

Responsible Lending Partnerships

There are many fintech and alternative lenders that are providing responsible and transparent small business lending products. Opportunity Fund is a founding member of the Responsible Business Lending Coalition (RBLC), a network of for-profit and non-profit lenders, brokers, and small business advocates. To promote responsible practices and combat abusive practices in small business lending, the coalition created the Small Business Borrowers' Bill of Rights, a cross-sector consensus on the rights that small business owners deserve and what lenders and brokers can do to uphold those rights. Since the creation of the Small Business Borrowers' Bill of Rights, nearly 60 small business lenders and brokers have committed to uphold these rights, and more than 30 advocacy and support organizations have endorsed them.

In 2016, Opportunity Fund and RBLC co-founder LendingClub, a marketplace lender, launched a pilot partnership, the first of its kind between a non-profit CDFI and a fintech lender. Opportunity Fund leveraged LendingClub's technology to provide an online application experience with pre-qualified offers to underserved small businesses who did not qualify for a loan with LendingClub, before applying its established relationship-based lending model to fund and service loans. This is an industry awarded example of financial inclusion where a leading fintech company and a leading non-profit CDFI came together to build a product where small businesses who do not fit well inside an algorithm-driven model can still receive transparent and fairly priced loans in a fast and easy online experience. Due to its success, in 2019, this partnership was expanded from 13 to 45 states.

High Speed and High Cost

Much of the small business lending by non-banks is done with old products which are promoted through new channels and new experiences to borrowers who previously did not have access to such capital. Many fintech and alternative lenders use highly automated underwriting intended to provide capital at a quicker speed than traditional providers. In addition, many alternative lenders do not require the same level of documentation or scrutiny that traditional small business lenders require. As a result, decisions are made sometimes within minutes which can be beneficial for small businesses who have immediate cash flow needs. On the other hand, while offers of quick cash can be very enticing, they can often times come at high costs, require payments that borrowers cannot afford, and lack the transparent pricing and terms that responsible loans entail.

The proliferation and promotion of loans from alternative lenders is overwhelming small business owners. Small business owners are inundated with calls, text messages, and ads from lenders offering short-term high cost loans. Lenders pay high referral fees to brokers who frequently and aggressively hound small businesses to accept loans without being able to fully understand the terms and cost.

MCA’s are not a new product and daily debits for repayment is not a new feature. In fact, these products and features pre-date most of the venture backed fintech lenders and large technology firms who offer them today. Structurally, there is nothing inherently wrong with a product where the repayment of the loan is tied to a proportion of sales. The problem is that most loans with this daily debit structure are being offered at extremely high rates and short terms with little pricing transparency and obscure disclosures. The cost structure of these products is also different from conventional installment loans or consumer loans which often surprises borrowers who did not expect to owe the full cost of the loan regardless of when it's paid off. In addition, although MCA providers deny the product is a loan, it is often promoted as a loan without disclosing the structural differences to the borrower.

Large technology firms have been lending to small businesses for several years. Some of these firms, such as Amazon and Shopify, tend to already have many small businesses as their customers. Other firms, such as Paypal, Stripe, and Square, have been providing other financial services to small business customers. These platforms and service providers have the unique advantage of near-zero cost customer acquisition and unique data insights to small businesses. Additional firms which possess these unique advantages are beginning to offer loans to their small business customers.

Unfortunately, we have seen some of these technology firms offer financing in the form of a typical MCA that lacks transparency and comes at high costs. The unique proximity these firms have to their small business borrowers creates a dangerously tilted power dynamic between the lender and borrower. Small businesses use large technology firms like Amazon and PayPal as the platform to operate their business. These borrowers cannot switch platforms in the same manner in which they can switch banks.

Opportunity Fund analyzed about 100 loan contracts of borrowers who came to us seeking refinancing after borrowing from alternative lenders. The average APR on these loans was 94%, and the highest we saw was 358%.[12] High cost financing, like the one many of our clients have experienced, is due to the desire for speedy underwriting processes. Many lenders may be basing their lending decisions primarily on monthly income, as evidenced by merchant processing history or inflows to a business bank account. The speed at which many fintech and alternative lenders provide financing are leading them to take on more risk. These lenders manage the elevated risk through inflated pricing that the typical borrower cannot afford, and through the expectation that the borrower will run out of cash and borrow again and again, running up loan fees in the process and landing them in a debt trap. The expectations that a borrower will refinance again and again is a core part of the business model of MCA lenders and other short-term high cost lenders.

Given the impact of a short-term high cost loan on small business borrowers, there is a stigma for the borrower which may make it difficult to obtain future bank financing. These borrowers are perceived to be riskier by banks and lenders who offer lower cost and longer term loans. In addition, many alternative lenders do not report successful loan repayment to consumer credit bureaus, further restricting small business owners' access to more traditional products.

Trends Towards Transparency

While the federal Truth in Lending Act requires consumer creditors to disclose key information about transactions in a clear and comparable way, no such national standard exists to protect the millions of small business owners seeking financing. The argument seems to be that small business owners are more financially sophisticated than consumers, and can figure out interest rates on their own. Small business owners are indeed sophisticated in their industries, but research indicates that a majority are not sophisticated at reading complex legal documents or understanding complex lending products.

The lack of required disclosures is a primary reason many small businesses fall into debt traps with short-term high cost financing. Small businesses have a hard time assessing the credibility of their lenders, especially when the lender can be a large technology firm, or often times a broker (online or offline). Surveys have shown that most small businesses would like to obtain a loan from known brand name banks, however, they have relatively little knowledge of non-bank

[12] Opportunity Fund: "Unaffordable and Unsustainable: The New Business Lending in Main Street," 2016.

lenders. The 2019 Federal Reserve Small Business Credit Survey showed consistent demand for new financing, with 43% of firms in the survey applying for new capital in 2018, in line with 40% in 2017.[13]

Last year, Opportunity Fund and the RBLC inspired, championed, and passed Senate Bill 1235 in California with the help of tens of thousands of small businesses and more than 500 California small business lenders, fintech companies, advocacy and community organizations, small business service providers and CDFIs. The new law created a path toward establishing the nation's first and most extensive set of truth in lending protections for small business borrowers, requiring lenders and other commercial financing companies to provide clear and consistent disclosures.

The California Department of Business Oversight recently released draft regulations to protect four million small businesses from predatory lending by mandating they be given the opportunity to understand the financing they are being offered in a clear, concise manner that enables informed comparisons across different options—including disclosure of APR and estimated monthly payments.

Small business financing has changed and policymakers across the nation are paying attention. Lawmakers in New York introduced a similar bill to SB 1235 in their last legislative session, and we expect other states to follow suit in the coming years. At the federal level, House Small Business Committee Chairwoman Nydia Velazquez has stated that she is working on bipartisan legislation to increase transparency in this industry.

In summary, many small business owners, and particularly minority and women business owners, are stuck between loan denials from traditional financial institutions and predatory offers from high cost, unregulated online and fintech lenders. Without sufficient data to measure these challenges at the national level, it is impossible to ascertain the true scope and depth of this problem.

Small Business Data Collection Is Essential and Doable

There is currently no single comprehensive data set available to analyze trends within the U.S. small business lending industry. Section 1071 mandates that the CFPB collect data on small business credit, including new data on race and gender. This data collection is critical to

[13] Federal Reserve Banks: "2019 Small Business Credit Survey: Report on Employer Firms," 2019.

understanding the credit needs and financing outcomes of small business owners in today's small business lending marketplace—particularly for minority and women business owners. When implemented, Section 1071 will provide essential information regarding the realities of small business financing needs and outcomes in order to enable industry, advocates, and the public sector to better meet the needs of all small business owners. We believe that the marginal added cost for a lender to collect and report this data to the CFPB is more than offset by the potential benefit to disadvantaged small business owners in the form of increased access to responsible capital.

The CFPB should collect data on both mainstream products, such as term loans, as well as alternative products, such as merchant cash advances, lines of credit and factoring to provide comprehensive data on *all* small business financing. It is critical that the CFPB collect data around the client's race, gender, and geographic location to understand both where and to whom discrimination may be occurring. Data should also be collected on interest rates, fees, and terms, as well as the performance of specific types of loan products, including default and repayment rates. Doing so would allow for proper evaluation of product effectiveness in responsibly serving small business financing needs. Lastly, careful analysis and evaluation should be done to determine if there should be any exemption from reporting data to the CFPB by lending institutions that originate a minimal number of small business loans (minimal in terms of both absolute number of transactions and as a proportion of an institution's total lending).

Relevant Examples of Data Collection

Some may argue that data collection is burdensome and difficult. However, there are numerous examples of thriving markets in which financial institutions collect and report comparable information on a regular basis. For example, despite limited resources, non-profit CDFIs across the country, including Opportunity Fund, collect and report data about our lending and customers to the CDFI Fund with the Department of the Treasury on an annual basis. There are over 1,000 CDFIs, many of which are small, community-based organizations. Information reported includes transaction level data such as amounts, terms and pricing as well as demographic information from small business borrowers.[14]

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[14] U.S. Department of the Treasury, Community Development Financial Institutions Fund

As another pertinent example, today's small business lending marketplace is in the same position that the home mortgage lending market faced before the Home Mortgage Disclosure Act (HMDA). HMDA requires financial institutions to provide mortgage data to the public and came about because of public concern over credit shortages in certain urban neighborhoods. There was anecdotal evidence that minority and underbanked populations were not being served, that capital flows fell short when they reached certain communities, but without data there was no proof. HMDA provided that proof.

As a result of HMDA, real, true access to capital became available for those communities. One analysis, looking at the period of 1993 to 1999 following the HMDA data expansion, found that the number of home purchase loans made to Hispanics increased 121.4%; to Native Americans, 118.9%; to African Americans, 91%; to Asians, 70.1%; and to Whites, 33.5%.[15] Over that period, the number of home purchase loans extended to applicants with income under 80% of the median increased 86.2%.[16] While there were certainly other factors at play driving these results, HMDA was a key part of that expansion.

Section 1071 can provide data needed to understand the current and future outlook of small business lending. We have evidence of a capital gap in the marketplace measuring, by some estimates, over $87 billion.[17] We need answers to basic questions: Who is and isn't being served in the current market? Who is providing access to needed capital? Are the products available the best fit to help businesses grow? HMDA answered these questions in the home loan marketplace. Section 1071 will do the same for the small business lending marketplace.

Conclusion

Opportunity Fund strongly supports the Section 1071 small business finance data collection effort if implemented thoughtfully and thoroughly. It should be implemented immediately to yield significant insights for small business lenders, policy makers, advocates, and most importantly, for small business owners, the backbone of our national economy.

[15] Harvard University, Joint Center for Housing Studies: "The Home Mortgage Disclosure Act at Thirty-Five: Past History, Current Issues," 2010
[16] Ibid.
[17] Next Street: "Next Street Launches New Capital Practice for Small Business Capital Enablement," 2019.