RESPONSIBLE BUSINESS LENDING COALITION

Testimony for the Record

Submitted to the
House Committee on Small Business

For the Hearing
"Transparency in Small Business Lending"
September 9, 2020

Submitted by the Responsible Business Lending Coalition

Chairwoman Velázquez and Ranking Member Chabot, the Responsible Business Lending Coalition (RBLC) thanks you for convening an important hearing on transparency in small business lending. The RBLC is the only cross-sector coalition of nonprofit 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. We are grateful to the Chairwoman for inviting RBLC member Luz Urrutia, CEO of Accion Opportunity Fund, to serve as a witness in this hearing.

Today's discussion on lending transparency could not have been timelier given the heightened importance of transparent small business financing disclosures amid the pandemic. Due to the business interruptions caused by COVID-19, small businesses need responsible financing now more than ever to bridge revenue losses and adapt their business models. Businesses seeking capital to weather the uncertain months ahead are currently presented with non-standardized or misleading disclosures from some financing companies, making it challenging to compare different financing options, choose affordable products, and avoid debt traps.

The lack of price transparency in small business financing today is undermining market competition, stymying innovation, and misleading small business into paying unnecessarily high rates. For small businesses already on the brink of closure amid the pandemic, choosing an unaffordable credit product unknowingly could be the difference between survival and failure.

Small Businesses Lack Access to Transparent Capital

The lack of transparency in small business financing is a problem that has created unnecessary burdens for entrepreneurs seeking capital since long before the COVID-19 crisis. Commercial financing has never been subjected to Truth in Lending Act, which requires transparent disclosure of pricing and terms for consumer credit products. This lack of transparency exposes small businesses to undue financial risk. In this regulatory gap, the small business credit marketplace has evolved and grown significantly in recent years, 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 detailing the fundamental financing rights that all small businesses deserve, and the practices that lenders must abide by to uphold those rights.[1] The Borrowers' Bill of Rights 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

[1] Responsible Business Lending Coalition, "Small Business Borrowers' Bill of Rights," 2015. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/bbor_for_web_-2020.pdf

products including lines of credit, merchant cash advances (MCA), and loans.[2] In the study, 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 is it 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)

[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
[3] Ibid.
[4] 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

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.		

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 a merchant cash advance 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 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 earning economic rent on their customers' lack of information.

Impact of Undisclosed High APRs on Small Business Borrowers

As Ms. Urrutia noted in her testimony, RBLC founding member 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 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. Opportunity Fund 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.

Addressing the Small Business Lending Transparency Problem

Small businesses have borne the brunt of irresponsible and non-transparent lending practices for too long. Main Street cannot afford the status quo to continue, particularly now given the additional financial burdens that COVID-19 continues to impose on small businesses. It is critical that policymakers take bipartisan action to bring commonsense rules of the road to small business lending. To start, lawmakers should require understandable and consistent disclosures

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[5] Rapid Advance, "RapidAdvance Merchant Cash Advance Program," 2016: http://web.archive.org/web/20161110041235/http://www.rapidadvance.com:80/merchant-cash-advance

[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

from financing companies to help small businesses to make informed decisions while enabling market innovation and access to a broad range of financing tools. Information asymmetry, where one party to the transaction has more information than the other, prevents free market competition that can foster market growth and drive down the cost of capital. Small businesses need access to clear information about the price and terms of financing products upfront so that they can make financial decisions that help, rather than harm, their businesses.

The RBLC applauds Chairwoman Velázquez for leading the way to small business lending transparency. On July 30, 2020, the Chairwoman introduced the *Small Business Lending Disclosure and Broker Regulation Act of 2020* (H.R. 7889). Building upon state bills passed and soon to be implemented in California and New York, H.R. 7889 would require all providers of small business financing (in amounts under $2.5 million) to disclose APR or estimated APR and other key terms to borrowers at the time a small business is approved for financing. This legislation would bring transparency to all small businesses nationwide just as small businesses face unprecedented economic uncertainty and record levels of business closures due to the pandemic. The disclosure framework detailed in H.R. 7889 has been supported by a variety of responsible private-sector fintech lenders and nonprofit CDFI lenders, as well as advocacy and civil rights groups. However, portions of the high-cost lending industry, including merchant cash advance and factoring providers, may continue to oppose the requirement to disclose APR or estimated APR as the basis for apples-to-apples comparisons of differently structured products.

High-Cost Lenders May Oppose APR Transparency

Higher-cost lenders express their 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 advance 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 collect their small business borrowers' historical sales volumes during the application process and

[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-when-browsing-online-lender-websites.pdf

[8] Ibid.

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.

Conclusion

The RBLC looks forward to continued dialogue with Committee Members on the need for greater transparency in small business financing and for APR disclosure in particular. We urge bipartisan support for H.R. 7889 that would create a level playing field for small businesses and lenders alike by requiring clear and consistent disclosures of pricing and terms, including APR for all products. This commonsense solution would not place burdensome restrictions on the types of financing that providers may offer or impose price ceilings. Rather, H.R. 7889 would simply provide small businesses with the information they need to understand complex financial products and choose financing that enables their business to grow and thrive. Thank you again, Chairwoman Velázquez and Ranking Member Chabot for bringing this important issue before the Committee today.

Signed,

The Responsible Business Lending Coalition

Members include:

Accion Opportunity Fund
Community Investment Management
Funding Circle
LendingClub
Opportunity Finance Network
Opportunity Fund
Small Business Majority
StreetShares
The Aspen Institute