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 (BBoR)

[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

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

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[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.

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[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