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Shining a Light on Small Business Credit: Promoting a Transparent Marketplace

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Executive Summary

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For many Americans, self-employment and running a small business can be an important pathway to the middle class, yet accessing credit to start or grow a business is more difficult, and potentially even more dangerous, than most realize.

While banks have historically provided the majority of small business credit in the United States, and still do, there's a hitch: Small business lending has high fixed costs relative to the returns banks can expect from their loans. This decline in profitability has meant a widening small business credit gap – even during an economic recovery.

Into the breach have stepped a host of companies hoping to leverage advancements in technology and the proliferation of data about small businesses to lower the cost of extending credit. As more small businesses utilize internet-based services for shipping, ordering, or record keeping; make or accept digital payments; and engage with social media, they are creating large, real-time datasets about their businesses that can be applied to credit underwriting. These developments are encouraging many new companies – or, in some cases, established companies with no history of extending credit – to begin offering small business financing products, often without the regulatory oversight and supervision applied to banks.

Since federal consumer financial laws apply only to consumer loans, when a loan of similar size is obtained for business purposes the lender is under no obligation to disclose standardized information about the product despite what are often comparable levels of borrower financial sophistication. Put simply, if a borrower takes out a loan as a consumer, he or she is protected. The same borrower seeking to expand his or her small business is not.

This issue brief will show that:

1. The credit gap for small business loans under $100,000 is widening because the loans most small businesses seek are the least profitable for traditional lenders to make.
2. Challenges accessing credit lead many small business owners to turn to financing products and services that are not subject to federal consumer protection laws.
3. Small business owners report frustration with high interest rates, unfavorable repayment terms, and a lack of transparency.

To address these problems, I propose:

1. Requiring simple, standardized disclosures to encourage transparency and ensure borrowers have relevant and accurate information to compare products and make prudent financial decisions.
2. Adopting comprehensive disclosure requirements that apply to loans, merchant cash advances, and other unique working capital products alike.

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INTRODUCTION

Before an entrepreneur can put an idea into action – or a fledgling restaurateur can move from a food truck into a storefront – they need credit to start or expand their business.

Access to financing is often one of the biggest hurdles small business owners face, particularly for the smaller loan amounts many new or very small businesses seek. According to the 2016 Small Business Credit Survey, a national collaboration of the 12 Federal Reserve Banks, more than half of small businesses (55 percent) seek loans of $100,000 or less; but, despite the economic recovery, this category of bank lending has fallen from 33 percent in 2008 to 22 percent in 2016, and continues to decline.[1]

It can be costly and time consuming for banks to acquire, underwrite, and service small business loans; revenues for small-dollar loans (less than $100,000) are typically lower relative to larger business loans; and information about the small business can be opaque. As a result, for many businesses, especially those that are new or very young (less than three years old) or do not have asset-backed collateral, obtaining a traditional bank loan can be difficult.

However, technology and the proliferation of data are changing the way small businesses seek and access credit. From online marketplace lenders like Funding Circle, Lending Club, OnDeck, and Kabbage to payments processors like PayPal and Square, there are a wide variety of non-bank lenders offering small business loans and financing products with an almost equally diverse range of rates and terms. This paper examines how these new entrants are changing the small business credit market for loans under $100,000; the concerns of some borrowers and borrower advocates about adequate protections; and the need for greater transparency to promote a robust and competitive small business credit market.

THE MARKET FOR SMALL BUSINESS LOANS UNDER $100,000

Demand

While the term "small business" is often debated, with some definitions going as high as 500 employees, many folks would be surprised to learn that over 80 percent of all businesses in the United States – not just those defined as "small" – are non-employer firms, meaning the owner is also the only employee.[2] Among these businesses, the demographic groups with the fastest-growing self-employment rates are women, minorities, and immigrants.[3] Ninety percent of the nation's minority-owned businesses and nearly 91 percent of woman-owned businesses are self-employed (non-employer firms).[4]

For many Americans "whose employment options are limited due to language barriers, lack of formal education, or a need for flexible work arrangements," self-employment can be an important pathway to the middle class.[5] Recent research from the Center for American Progress, for example, found that business ownership is a critical component of wealth building for low-income families. African-American business owners have more than $52,000 in total wealth compared to just over $7,000 for non-business owners.[6] The same holds true for Hispanic business-owning households, which have more than $41,000 in total wealth on average compared to $16,000 for non-business owners.[7] Importantly, wealth building benefits both business owners and their communities. Greater savings helps families weather financial setbacks and move up the economic ladder, but it also means these households spend more money boosting their local economy, too.

Most businesses are also small in terms of average annual revenue. Seventy-six percent of all businesses in the United States have average annual receipts less than $100,000.[8] For minority-owned and woman-owned businesses, that figure is even higher: 86 percent of minority-owned businesses and 88 percent of woman-owned business bring in less that $100,000 per year.[9]

Not surprisingly, very small businesses tend to seek small-sized loans. In 2016, more than half (55 percent) of employer firms surveyed by the Federal Reserve sought less than $100,000 in financing.[10] Demand for small loans is even higher among non-employer firms: in 2014, roughly 50 percent of them sought less than $25,000 in credit and 75 percent sought less than $100,000.[11]

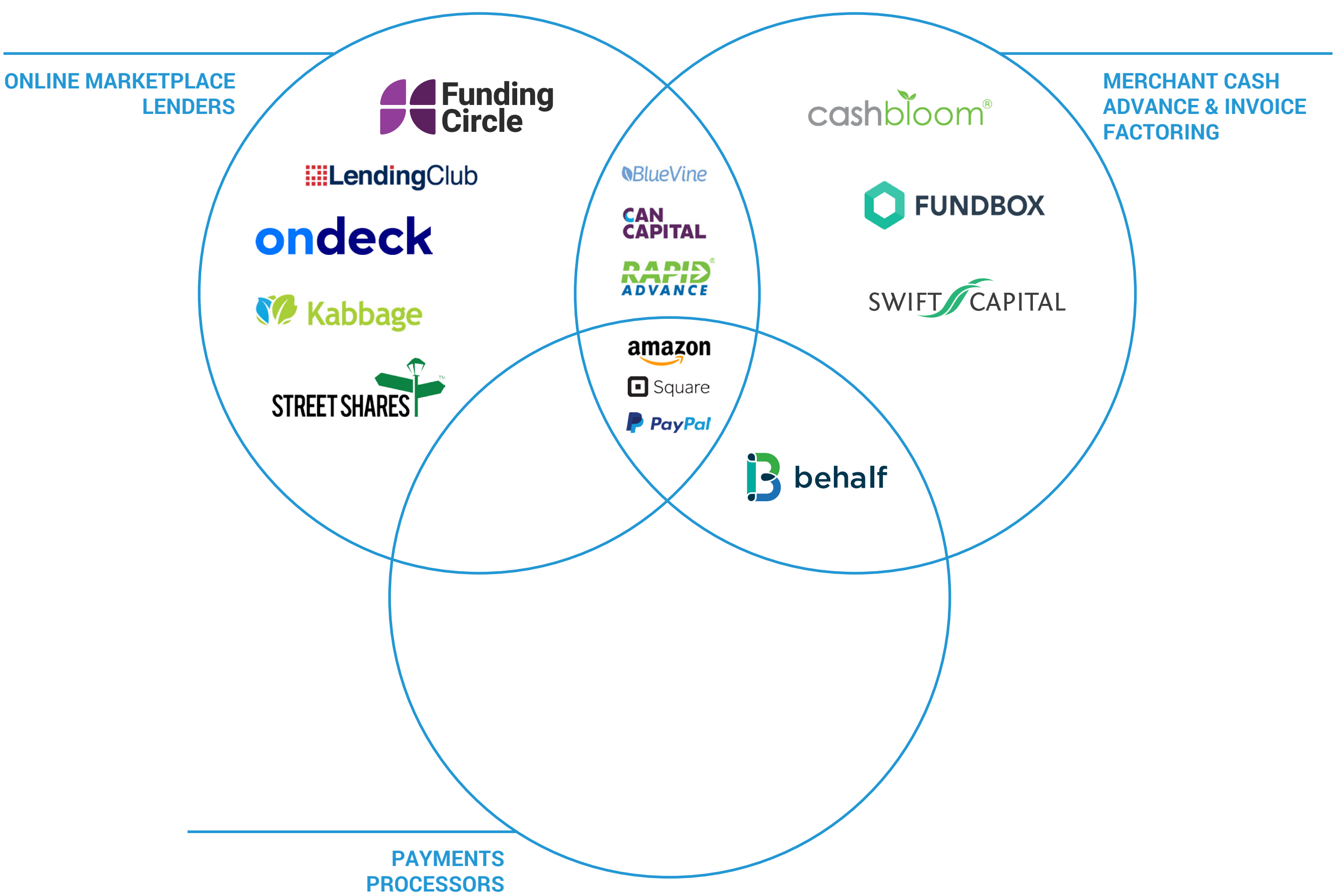
Supply

While small loan amounts may be the most sought after, they are also becoming the most difficult to obtain. For decades, community banks (those with less than $10 billion in assets) were the bedrock source of relationship lending to businesses in their communities. Community bankers are often closest to their borrowers and in a unique position to assess and address the credit needs of their customer base. This can lead to more effective risk assessments and better outcomes for lenders and borrowers. But this type of high-touch lending is also expensive – it costs about the same to underwrite a $5 million dollar loan as a $200,000 loan.[12] As a result, loans in the smallest category, term loans under $100,000, have become harder to come by.

A recent study by the Federal Reserve Bank of Chicago, using flow of funds data, showed just how dramatic the shift has been. From 1997 to 2015, community banks' share of originations less than $100,000 declined from 82 percent to 29 percent in less than 20 years.[13,14] It is estimated that this market share has been captured by larger banks (those with more than $10 billion in assets) – which steer small businesses with limited credit needs into business credit card products with higher revenue generation potential – and a growing market of non-bank alternative lenders.

Financing providers first offered small business merchant cash advances in the late 1990s, and the first U.S. online marketplace lending platforms appeared in the mid-2000s. Today, there is a wide variety of non-bank lenders offering small business loans and financing products – with an almost equally diverse range of rates and terms.

FIGURE 1: Some Examples of Online Finance Providers



Online Marketplace Lenders: Online marketplace lenders use data-driven algorithms, online and automated operations, and investment capital to lend directly or indirectly to small businesses and consumers. In particular, online marketplace lenders are offering small business owners expedited loan decisions – often in 48 to 72 hours – for small-sized and short-term unsecured loans. Products offered to small businesses include term loans, lines of credit, and equipment financing loans. The average small business loan amount was $40,000 in 2016.[15]

One of the most innovative features of online marketplace lenders is the use of non-traditional data to determine a borrower's creditworthiness. Small business owners today are more likely to use online bookkeeping and operations management tools such as cloud computing, smart phones, tablets and high-speed internet for day-to-day operations. According to a survey by the National Small Business Association, 85 percent of small businesses purchase supplies online, 83 percent manage bank accounts online, 82 percent maintain their own website, 72 percent pay bills online, and 41 percent use tablets for their business.[16] As such, there is now an unprecedented amount of online data available on the activities of these small businesses. Online marketplace lenders are able to use algorithms to pull real-time business data from these varied sources to lower the cost of underwriting small loan amounts.

Merchant Cash Advances: A merchant cash advance product is a purchase of future receivables at a discount that is repaid as a percentage of future sales (typically 5-50 percent of daily transactions) until the advance is paid off. While the distinction may not be clear to the borrower, a merchant cash advance is technically not a loan. A small business is selling a set percentage of its future sales in return for a lesser cash amount today. Merchant cash advances have been around the longest and, since the product is not technically underwritten, it is least likely to make use of technological advances to lower the cost of credit.

Payments Processors: Some payments processors with a largely small-business customer base have begun to offer small-dollar, short-term working capital finance to small business customers on their platforms. For instance, PayPal Working Capital charges a one-time fixed fee for financing and allows the borrower to chose the rate of repayment (between 10 and 30 percent of daily sales) that will determine the term and total cost of the financing. These products, depending on the vendor, can be classified as an advance, a loan, or a hybrid.

Market Size

Over the past decade, online marketplace lending has grown exponentially. In 2015, Morgan Stanley estimated small business online marketplace loan originations were about 2 percent of the total small business lending market but were projected to grow to 16 percent of all small business loans by 2020.[17] Mills and McCarthy estimate small business online loan originations were about $5 billion in 2015 and growing at 120-150 percent year over year.[18] This is supported by the Federal Reserve's Small Business Credit Survey, which found 1 in 5 small businesses applied to an online marketplace lender in 2015, and 70 percent were approved.[19] This represents significant market penetration in a relatively short period of time. By contrast, merchant cash advance products, which have been around for longer, are estimated to total about $3 billion of funding annually.[20]

A GAP IN SMALL BUSINESS BORROWER PROTECTIONS

In the summer of 2015, the U.S. Treasury Department issued a Request for Information (RFI) on online marketplace lending, which received nearly 100 responses from individuals, businesses, advocates, and trade associations across the stakeholder spectrum on the challenges and opportunities of this emerging source of new credit for small businesses.[21] The RFI responses were supportive of the potential of data-driven underwriting to expedite credit assessments, reduce costs, and expand access to credit for small businesses. However, many responses also pointed to the gap in borrower protections in place for small businesses.

Some RFI responses suggested that the way in which the cost of credit is disclosed should be standardized so borrowers are able to comparison shop as well as understand the true cost of their loans. The RFI findings concluded that small business borrowers need greater transparency around pricing and terms for credit products and that these protections should be applied uniformly across financial institutions and online marketplace lenders.

Also in summer 2015, the Federal Reserve Bank of Cleveland conducted focus groups with business owners of firms with 2-20 employees and under $2 million in annual revenues from across the U.S. The focus groups included discussions and comparisons of traditional bank loan products, online marketplace loans, and merchant cash advances. Again, the research found that "small businesses find it difficult to compare products" and "virtually all the focus group participants said they wanted clearly stated product costs and features and an easier way to compare product offerings."[22]

These findings were further supported by the 2015 Federal Reserve's Small Business Credit Survey, which found that small businesses approved for financing from online marketplace lenders were widely dissatisfied with their experiences. The top three frustrations noted by small businesses were high interest rates, unfavorable repayment terms, and a lack of transparency.

PROMOTING A ROBUST MARKET AND SAFE ACCESS TO CREDIT THROUGH TRANSPARENCY

While the gap in small business borrower protections is widely acknowledged, policy solutions to address the gap are complicated by a desire not to restrict access to credit and to support continued innovation in the financial services industry. There are several positive reasons to believe this is possible. First, similar arguments were made about the negative impact the Credit Card Accountability and Disclosure Act of 2009 (CARD Act) would have on consumer credit cards. In fact, the CARD Act's protections, which go much farther than anything proposed in this paper, led to greater transparency, lower consumer fees overall, and consistent rates of return for credit card issuers in line with historic norms.[23] Second, as further evidence that basic protections need not place an undue burden on finance providers, many responsible companies, as discussed below, are already taking steps to address some borrower concerns. And thirdly, transparency is critical to promoting market competition, which should ultimately provide borrowers better products at better prices.

There are two notable industry efforts underway to promote clear and fair small business lending disclosures and protections: the Small Business

Borrowers' Bill of Rights and the SMART Box Initiative.

The Small Business Borrowers' Bill of Rights is a product of the Responsible Business Lending Coalition (RBLC), a network of for-profit and non-profit lenders, brokers and small business advocates that includes Accion, Aspen Institute, Community Investment Management, Fundera, Funding Circle, Lending Club, Opportunity Fund, and Small Business Majority. Lenders, brokers, and online marketplace lenders that sign the Small Business Borrowers' Bill of Rights pledge to adhere to a set of common standards around transparent pricing and terms, non-abusive products, responsible underwriting, fair treatment from brokers, inclusive credit access, and fair collection processes.

The Innovative Lending Platform Association (ILPA), in partnership with the Association for Enterprise Opportunity (AEO), has created a model small business lending disclosure called the SMART (Straightforward Metrics Around Rate and Total Cost) Box. The SMART Box presents small business borrowers with a chart of standardized pricing comparison tools and explanations, including various total dollar cost and annual percentage rate metrics that enable a comprehensive pricing comparison of loans of equivalent duration. The ILPA membership includes OnDeck, Kabbage, and CAN Capital, which offer the SMART Box to their customers when applying for small business loans.

While these efforts are admirable and prove that basic borrower protections need not restrict access to credit or place an undue burden on credit providers, they are also voluntary and stop short of ensuring all small business borrowers have access to standardized, relevant, and accurate information when making credit decisions. To ensure a truly transparent and competitive market, disclosure requirements should apply equally to all small business financing products regardless of whether the provider is a bank, credit card, merchant cash advance, online marketplace lender, or any new companies yet to emerge.

This paper proposes federal legislation to extend the Truth in Lending Act (TILA) disclosure requirements (Regulation Z) to small business "loans or credit products of $100,000 or less where the use of proceeds is for business purposes." The $100,000 threshold allows policy makers to target protections to borrowers that are more likely to have very small businesses and to approach financial decisions as they would in their daily life as consumers. Importantly, since merchant cash advances and some working capital products offered by payments processors are not defined as loans, legislation would need to explicitly define this type of financing as a covered credit product.

FIGURE 2: Current Consumer Protections & Proposed Small Business Projections

			INDUSTRY-LED INITIATIVES		
	CURRENT FEDERAL CONSUMER PROTECTION	CURRENT FEDERAL SMALL BUSINESS PROTECTION	SMALL BUSINESS BORROWER BILL OF RIGHTS	SMART BOX	PROPOSAL
FINANCIAL DISCLOSURES					
STANDARDIZED APR	✓	✗	✓	✓	✓
INTEREST RATE	✓	✗	✓	✓	✓
FINANCE CHARGES	✓	✗	✓	✓	✓
AMOUNT FINANCED & BORROWING LIMITS	✓	✗	✓	✓	✓
TIMING OF DISCLOSURES	✓	✗	✓	✓	✓
ANY CHANGE IN TERMS	✓	✗	✓	✓	✓
PAYMENT SCHEDULE	✓	✗	✓	✓	✓
MINIMUM AND MAXIMUM PAYMENTS	✓	✗	✓	✓	✓
THIRD-PARTY AGREEMENTS	✓	✗	✓	✓	✓
DEBT COLLECTION PRACTICES					
COMMUNICATION WITH BORROWERS	✓	✗	✓	✗	✓
VALIDATION OF DEBTS	✓	✗	✓	✗	✓
PROHIBITED PRACTICES	✓	✗	✓	✗	✓
CIVIL LIABILITY	✓	✗	✓	✗	✓

Below is a list of disclosures that could be applied to small business loan or credit products of $100,000 or less:

- *Standardized APR:* Defined as the cost of credit expressed as a nominal yearly rate. This should be expressed inclusive of all fees and finance charges.
- *Interest Rate:* Simply the rate of interest expressed as a nominal yearly rate exclusive of any fees or charges.
- *Finance Charges:* Defined as including any and all costs of small business credit measured in dollars and cents. This typically includes interest, transaction fees, origination fees, and any third-party fees such as broker fees. A comprehensive list of all finance charges and fees should be mandated.
- *Amount Financed (term) or Borrowing Limits (revolving):* Defined as the total loan amount less any prepaid finance charges for term credit or the maximum credit limit for revolving credit.
- *Timing of Disclosures:* Disclosures should be provided with the credit offer and prior to the borrower's acceptance of the loan or credit product.

- *Any Change in Terms:* Consistent with the CARD Act, borrowers should receive notice at least 45 days before the effective date of an increase in APR or any other significant change.
- *Payment Schedule (term):* Includes all payments scheduled to repay principal, interest, and any other finance charges incurred after closing.
- *Minimum Payment (revolving)*: The minimum payment required and an estimate of the time to pay off the outstanding amount, along with the cost of interest incurred, with the minimum payment.
- *Third-Party Agreements:* Disclosures should address the relationship between the lender and any broker or third party, describing the relationships, any fees, or conflicts of interest.

Addressing APR for Merchant Cash Advance and Unique Working Capital Products

While a standardized APR works well for term and revolving credit, it can be difficult to apply in a meaningful way for some products like merchant cash advance, factoring, and other unique working capital arrangements. That is because these products typically utilize discounts as opposed to interest rates. For example, for $20,000 today a small business agrees to pay 10% of sales until it has repaid $25,000. Many businesses use these types of products because they are easily understood and aligned with sales volumes. However, given the short-term nature of the product – sometimes only a few weeks to a few months – and the undetermined term of repayment, a standardized measure such as an annual APR may be quite high and not necessarily relevant if the total costs of credit and terms are transparent and acceptable to the borrower.

While less-responsible providers will argue it is not possible to apply standard disclosures to their products for this reason, certain online lenders and payments processors that adhere to the SMART Box disclosure are moving to voluntarily list a TILA-compliant APR for these loan-like products.[24] The opportunity for enhanced disclosures certainly exists in the merchant cash advance and factoring market; but, because it is not considered closed- or open-ended credit, borrower advocates have expressed concerns that imputed APR calculations may be manipulated by abusive actors.

Addressing Brokers and Third-Party Affiliates

The influence of small business loan brokers over businesses seeking credit from online lenders is substantial. Nearly half (47 percent) of online applicants cited brokers as their secondary source of financial information behind their financial institution.[25] However, unlike the mortgage broker regulatory regime, there are no consistent state licensing regimes or rules governing behavior for small business loan brokers. This has led to reports of lack of transparency and higher loan costs due to the pass-through of high fees and commissions.[26] Requiring disclosures to include any relationship between the lender and a broker or third party and describe the relationships, any fees, or conflicts of interest as listed above would be a low-cost way to shed light on some of the challenges with this market and ensure borrowers are fully informed of extra costs they may be incurring.

Ensuring Fair Debt Collection Practices

While there are no federal laws that regulate third-party commercial (business-to-business) debt collection or provide guidelines for the conduct of commercial debt collectors, many online marketplace lenders already support the principles outlined in the Fair Debt Collection Practices Act (FDCPA), an existing consumer protection. The Small Business Borrowers Bill of Rights, an industry self-governance initiative, explicitly states that its signatories adhere to the spirit of the FDCPA. In addition, some states do regulate commercial debt collection or license commercial debt collection firms, but protections are inconsistent nationwide. Given existing state licensing regimes and certain self-governance initiatives, the application of uniform commercial debt collection standards may prevent abusive practices while remaining minimally disruptive for incumbent firms that do not engage in abusive practices.

CONCLUSION

Small businesses are the foundation of our communities and the largest single source of new job growth in our economy. Over the past two decades, small and new businesses have been responsible for creating two out of every three net new jobs.[27] While technology and financial innovation are making it possible for new companies to expand access to credit for small business owners, more must be done to ensure products are safe and affordable for borrowers in order for the broader benefits of small business growth and job creation to be fully realized by all of us.

About the author

Jessica Milano is the former Deputy Assistant Secretary for Small Business, Community Development, and Housing Policy at the U.S. Department of the Treasury under the Obama Administration and a current member of the Board of Directors of Small Business Majority, a national small business advocacy organization founded and run by small business owners.

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