

Bridging the Small Business Capital Gap: Peer-to-Peer Lending

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Opening Acknowledgments

Mr. Chairman, Ranking Member Velazquez, and Members of the Committee. I am Sam Hodges, co-founder of Funding Circle, and a small business owner myself. I am here to talk about how peer-to-peer (“P2P”, also known as “marketplace”) lending is playing a vital role in delivering capital for great small businesses all across the country, filling the gap left as banks have pulled back from this important segment.

Before founding Funding Circle, I was very much like the aspiring entrepreneurs and hard-working small business owners in your districts. Starting in 2009, my partners and I built up a successful chain of fitness businesses all across the country. As we pushed to open new locations, however, we found that, despite strong traction and personal credit, we were repeatedly denied a loan that could help us grow our business. That experience informed our decision to launch Funding Circle, as a better way for small businesses to get loans. As you know, all across the country, America’s small business owners work around the clock to serve their customers and their communities, create jobs, and support their families. As members of this Committee, I am sure you share our conviction that making sure that the rules of the road for these small businesses are well laid is a critical element for ensuring prosperity in our country.

Introduction

Founded in 2010, Funding Circle is the leading global marketplace lender dedicated to small businesses. Over the past five years we have helped over 8,000 small business owners obtain over \$1 billion in loans. We currently lend out approximately \$75 million dollars per month to a wide range of small businesses in both the US and the UK – from a logistics business in the Midwest, to an education services company in suburban Atlanta, to a multi-unit salad company in San Francisco, we are helping the 28 million small businesses in the United States gain access to the capital they need to grow and expand. Our average loan size is \$125,000 and our average borrower is a business that has operated for eight or more years, has ten or more employees and earns over \$1 million annually in revenue. Our borrowers are the bedrock, growing, main street small businesses that power our economy. Not only are our loans delivered quickly and in a highly-transparent fashion, they are also fairly priced, with interest rates typically in mid-single digits through the mid-teens, and in increments of \$25,000 to \$500,000 over a one to five year term. Our loans address the core of the small business credit gap: term loans that a small business owner can use to expand her store front, open a new location, hire more staff, or launch

a new product. These loans resemble the type of loan that local banks made to small businesses two or three decades ago but which, more recently, have largely dried up.

As you know, small business is a key pillar of American economic strength. Small businesses provide roughly half of American jobs, account for a majority of new job creation since 1995 and also serve as critical onramps for small business owners to broader prosperity – which in turn helps address income inequality.¹ Yet, if you ask the average main street small business owner whether they have the credit access they need to grow and expand, most likely the answer you will hear is a resounding “no.” Even as our domestic economy experiences a recovery, many small businesses remain left behind by banks who largely do not view smaller-dollar commercial lending as core to what they do.

Many of these topics around small business capital access have been well trod by other congressional witnesses, so I would like to tighten my focus to three parts of the story that to-date have not been well-told in this forum: first, I will briefly provide an overview of my company, Funding Circle, and the role that we and other marketplace lenders are playing in this part of the economy; second, I will address why the Jumpstart Our Business Startups Act (the “JOBS Act”) presents a missed opportunity so far in terms of facilitating access to capital for small businesses in the United States; and, finally, I will share how the rise of responsible marketplace lending could transform access to high-quality, non-bank credit for the majority of American small businesses that otherwise remain stuck with only high-cost, short-term products.

Background on the P2P and Marketplace Lending Industry

The past decade has seen the development of a new category of lenders: marketplace lenders (oftentimes also referred to as “peer-to-peer” or “P2P” lenders) provide a radical, new and transparent way of connecting providers of capital – lenders – with consumers and small businesses who need it to fund investments and/or consumption. Put simply, we and other such platforms provide a digital marketplace format, supported with advanced credit analytics, to match the supply of capital with demand. The earliest marketplace lenders – Zopa in the UK and LendingClub and Prosper in the US – focused on delivering capital to consumers seeking capital. Over the past six years we at Funding Circle and other platforms around the world have applied a similar concept to an even more important category: getting capital in the hands of small businesses who need it the most. The following diagram summarizes how our marketplace works:

¹ Karen Gordon Mills & Brayden McCarthy, *State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (Harvard Business School Working Paper 15-004, July 22, 2014).

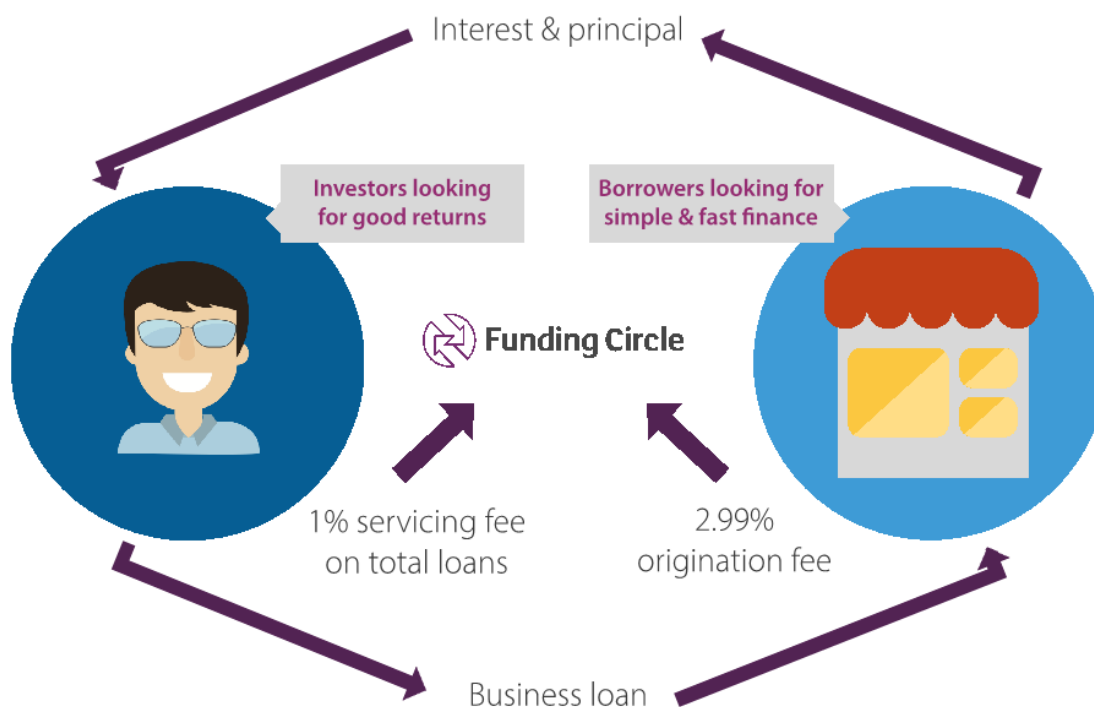


Exhibit 1: How Marketplace Lending Works

From our experience in talking with bank partners, small businesses owners, and investors who lend through our platform, we have identified four key reasons why this category of lender is emerging as so successful:²

1. **Regulatory Pressures on Banks.** The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and other post-financial crisis regulatory frameworks dramatically increased compliance costs for banks. The Basel Accords require banks to increase and improve their capital ratios by holding more capital against many loans they make. These factors make certain types of lending very expensive and generally less attractive than other areas where banks can make more money.
2. **Shifts in Distribution Costs and Consumer Preferences.** Most banks maintain extensive brick-and-mortar distribution networks. While helpful for some lines of business, this distribution channel is very costly when it comes to smaller loan sizes (less than \$1 million in many cases). At the same time, many small business owners are busy running their businesses and prefer to apply for credit online, in the same way they obtain an increasing number of services. The hard truth is that for many banks it is simply not

² For additional research and analysis on this point, see Charles Moldow, *A Trillion Dollar Market By the People, For the People How Marketplace Lending Will Remake Banking As We Know It* (Foundation Capital Working Paper, May 2014).

worth the time and expense to underwrite a loan for under \$1 million, which is what many small businesses need to grow and succeed.

3. **Evolution of Risk Analytics.** A profusion of data and more advanced analytical tools enable digitally-native lenders to make better risk assessment decisions faster, while still complying with federal and state lending rules that govern credit decisioning (e.g., the Equal Credit Opportunity Act). These data-driven approaches not only allow such lenders to extend credit to previously underserved communities of borrowers, but they also provide a much better borrower experience across the board (given the ability to turn around credit decisions in days or weeks instead of months).
4. **Investor Appetite for Direct Investment Opportunities.** A diverse group of investors are interested in stronger-yielding products, and are comfortable investing directly through marketplace platforms. Rather than investing in complex securitizations, many investors are willing to lend directly and build their own diversified investment pools.

The first and second factors above have contributed to a situation where demand for small business credit meaningfully outstrips supply. By one measure, small business lending (indexed to US GDP) has declined by 3-5% per year since the financial crisis, even as an ever-increasing share of small business owners seek credit and express optimism around how they could profitability drive growth in their businesses if given access to the capital they need.

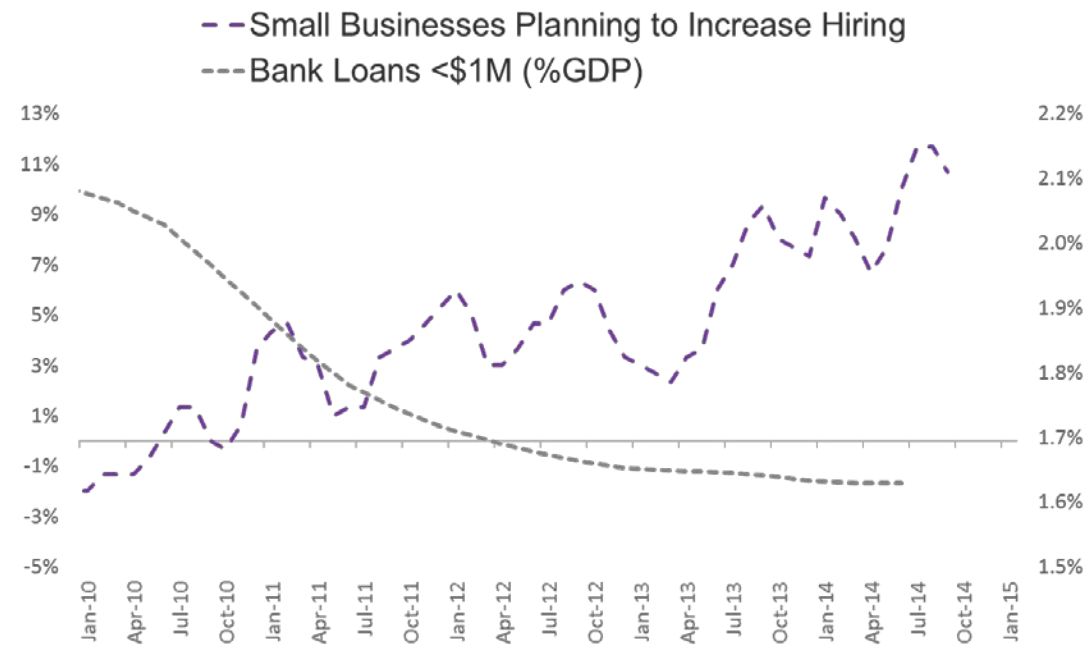


Exhibit 2: Small Business Growth Potential vs. Bank Lending³

³ Funding Circle based this analysis on source data from the National Federation of Independent Business and the Federal Deposit Insurance Corporation.

To help fill this gap, marketplace lenders like Funding Circle developed data-driven online investment platforms where a mix of different investors can put money to work in small businesses. This year we anticipate lending over \$1 billion to great small businesses across the US and the UK, and we think that this model is still early-on in its vast potential.

Marketplace Lenders vs. Short-term High-rate Credit Providers

Without access to bank loans, or bank replacement-type products such as the fully-amortizing term loans that Funding Circle provides, small businesses seeking debt capital commonly enter into costly and burdensome short-term credit arrangements. For example, a small business may take a cash advance in exchange for allowing a credit provider to deduct a portion of its credit or debit card sales each day until the entire amount of the advance is repaid in what is generally called a “merchant cash advance.” Or, a small business might borrow against projected future cash flow by taking a short-term “cash flow loan” requiring automatic daily repayments. While appropriate in certain circumstances – funding inventory purchases, or as a source of emergency funding, for example – such credit products oftentimes lead small businesses to use a short-term financing arrangement to cover longer-term funding needs. Moreover, in the current environment, a large share of small businesses qualify for short-term, high-rate loans while lacking access to more affordable long-term financing alternatives. These largely unregulated lenders typically charge small businesses extremely high interest rates and higher fees – oftentimes in the 50-100% APR range – to compensate for their much less rigorous underwriting processes. These two attributes – short durations and very high effective rates – drive many small businesses who use such credit products into downward cycles of re-borrowing in which they take out more and more debt to roll over their repayment obligations. At Funding Circle we see the damage these arrangements can inflict on small businesses – otherwise healthy companies are throttled by overwhelming and unexpected debt service requirements.

Let me now turn to your work and what we see as some important opportunities for Congress to help small businesses access the capital they need to create jobs, grow, and contribute to your communities: First, we would recommend a few modifications to the JOBS Act that would further accelerate the formation of capital online in support of small businesses.

The JOBS Act: A Potential Missed Opportunity in Capital Formation for Small Business

As an online marketplace for small business credit, Funding Circle is frequently asked: did the JOBS Act make our business possible? As much as I'd like to say that the Act has significantly assisted in the development of this market, the reality is that Funding Circle and other marketplace lenders work within the strictures of much older regulatory regimes that seek to protect borrowers and investors. For example, a complex web of federal and state commercial

lending laws govern our lending and servicing operations, while more traditional securities regulation, particularly the Securities Act of 1933 (the “Securities Act”), the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act, govern our capital formation activities. If anything the JOBS Act seems to be a missed opportunity to reduce some of the regulatory burdens placed on businesses that are seeking to form capital online. Indeed, although many of the Act’s changes have proven beneficial, the Act fell short of one of its major aspirations – to meaningfully accelerate the formation of capital – particularly loans – for main street small business in the United States. Put simply, the Act, read as a whole, does not provide a viable approach for debt crowdfunding – *e.g.*, an avenue for helping small businesses secure loans online and so, despite all of the hard work that Members of Congress did across the aisle to pass the JOBS Act, main street is not seeing all of the benefits that Congress intended.

Unlike a venture-backed start-up, most small businesses are and should rightly be financed with loans, not equity; oftentimes, small businesses never “exit” and instead generate economic value through steady cash flows, which accrue to a small business owner and her employees. With sub-\$1 million small business lending at its current low, small businesses need a better way of raising the funds they need to grow and expand now more than ever – and unfortunately the JOBS Act offers no such provisions. As such, we view the JOBS Act as a missed opportunity to help small businesses raise capital.

Three Proposed Refinements to the JOBS Act

The authors of the JOBS Act intended to modernize financial regulations to allow for businesses to raise capital from the public while ensuring investors and the public are adequately protected. The Act, however, has failed to provide an effective means for businesses to raise debt capital, *i.e.* through traditional debt markets, peer-to-peer models, or “debt crowdfunding.”⁴ Specifically, three core provisions of the Act hinder its suitability for the small businesses seeking loans to issue debt, namely:

1. **Limitations on funding portals from providing “recommendations” or otherwise curating investment opportunities.** To appropriately gauge the risk and return characteristics of debt securities (which generally have more limited upside than equity securities and whose returns are driven by the creditworthiness of an issuer), investors generally rely on third-party ratings and/or independent verification of an issuer’s creditworthiness. The Act, however, specifically prohibits funding portals from providing assessments of issuers – even through provisioning of third-party scores and/or ratings – or otherwise curating investment opportunities.
2. **Onerous disclosure requirements for debt issuers.** The Act does not distinguish between appropriate levels of disclosure for issuing debt as opposed to equity. Although a certain level of disclosure is critical for either type of investment opportunity, the

⁴ “Crowdfunding,” broadly defined here, includes peer-to-peer platforms seeking to match investors with persons or entities seeking debt or equity financing.

specific prescribed disclosure requirements should better correlate to the relative risks of a particular type of security and issuer. For example, senior debt carries less risk than common stock offered by the same issuer, and thus should merit different disclosure standards. As written, the Act calls for a level of disclosure that makes debt crowdfunding disproportionately costly to an issuer.

3. **Strict limitations on the business models of debt crowdfunding portals.** An important intended benefit of the Act for issuers is limited preemption of state securities laws. In order to maintain this preemption, however, no associated parties may receive compensation for helping an issuer (the small business) raise capital either through a funding portal or other means. In equity crowdfunding, funding portals can receive compensation based on the performance of the issuers' equity securities – *e.g.*, carried interest on equity investments. In debt crowdfunding, where returns come in the form of regular interest payments, any split of interest fees or up-front commissions (whether paid by the borrower in the form of an origination fee, or paid by the investor in the form of an investment commission) would likely cause the issuer and the portal to lose preemption from state securities laws, meaningfully limiting the ability to form capital from a wide base of investors.

For these and other reasons, the JOBS Act does not provide small businesses an appropriate new method for forming debt capital. We detail each of these below – amendments to these sections of the Act should dramatically reduce the legal cost and barriers to debt crowdfunding, while still maintaining a robust investor protection regime.

Limitations on Providing Advice and/or Curating Opportunities

The Act exempts funding portals from broker-dealer registration, but rules proposed by the Financial Industry Regulatory Authority, Inc. (“FINRA”) and the Securities and Exchange Commission (the “SEC”) nevertheless impose significant restrictions on funding portals. Specifically, the Act authorized the SEC to unconditionally or conditionally exempt funding portals from the burdensome broker-dealer specific regulations so long as some authority, whether a self-regulated organization, such as FINRA, or the SEC, regulates the funding portal. Among other restrictions imposed, a funding portal may not offer investment recommendations or advice (discussed below), participate in solicitation of purchasers or sellers to buy or sell securities displayed on the portal, or deny issuers access to the portal absent suspicion of fraud (meaning that portals cannot curate investment opportunities).

Funding Circle believes the Act should be amended to lessen certain restrictions on funding portals that inhibit the efficient formation of capital and offer little, if any, investor protection. Among other changes, the Act should be modified to allow portals to provide information on credit (loan) investments hosted on a portal. Disclosure to potential investors of independently verified data and data generated by trusted and regulated third parties (such as credit rating agencies) regarding investments on funding portals increases transparency for investors. This disclosure would better protect investors and promote efficient capital formation by providing

sufficient data for investors to discern between creditworthy issuers and riskier issuers. The early experience of investors on Prosper, one of the earliest peer-to-peer lenders, supports this view. Prosper started with an open, unfiltered marketplace and, in those early days, Prosper investors directly evaluated loan opportunities and bid on them based on their investment preferences. This auction format allowed investors to artificially bid down interest rates on loans. Even though Prosper offered a product well-positioned for high returns, its average investor from 2005 to early 2009 lost 4.95% per year.⁵ If Prosper had included additional disclosures to investors from the outset, perhaps it would have attracted those investors who truly had the appetite for the risk offered.

Under current securities laws, disclosing information useful for evaluating a loan investment, even if provided by a trusted third party, would trigger various regulations, including broker-dealer registration requirements. The specter of these additional legal obligations potentially harms, rather than protects, investors by dissuading portals from disclosing this useful information. Some of these restrictions may make sense in the context of equity crowdfunding, but they make little sense in the context of debt crowdfunding, when investors will rightly seek verification of a borrower's creditworthiness, and where an abundance of standardized metrics already exist for investors to effectively evaluate risk.

Overly-Onerous Disclosure Requirements for Issuers of Debt Securities

The Act set out to update securities laws to ease the regulatory burden on capital formation – to better serve issuers of all sizes and reduce the barriers for non-wealthy investors to access markets. To that end, the Act's disclosure requirements (to be promulgated by the SEC and FINRA) should not exceed what is necessary to protect investors. Extensive disclosures raise the cost of crowdfunding, which cuts against the spirit and purpose of the Act and provides few extra protections to investors.

Funding Circle suggests determining the appropriate level of disclosure for an offering on a risk basis.⁶ The Act should calibrate disclosure requirements based on the type of investor and security. Although “sunlight is said to be the best of disinfectants” and provides the best investor protection, the Act does not sufficiently balance absolute disclosure with the transactional and operational cost associated with disclosure. For instance, the disclosure requirements in the Act do not sufficiently distinguish between accredited investors and non-accredited investors. Moreover, the Act does not distinguish between equity and debt securities. Debt securities, which have priority claim over equity securities in insolvency proceedings, might merit a lower disclosure standard, because debt securities typically entail less risk than equity securities.

⁵ For more information on Prosper's early investor return data, *see* <https://www.prosper.com/invest/performance.aspx>.

⁶ The Act tiers disclosure requirements based on target offering amount but does not fully adopt a risk-based disclosure relating to the type of security and investor.

Limitations on “Portals” Business Models

Another chief benefit of the JOBS Act is notionally to provide issuers with limited preemption from state securities laws. Under the Act, state registration is not required if an issuer conducts an unregistered offering under Rule 506 of Regulation D under the Securities Act (“Rule 506”) so long as any person (*e.g.*, a portal) associated with the issuer is not compensated in connection with the sale of the securities. The SEC, however, will likely view debt originators’ origination fees for loans to borrowers through crowdfunding as “compensation.” Debt originators in the peer-to-peer space often earn revenue through origination fees and, as a result, do not likely qualify for state securities law preemption afforded by the Act. This potential exposure to state securities laws significantly limits peer-to-peer debt origination, especially in light of state-specific lending restrictions and the multifarious risks of regulatory sanctions (across any states where a portal works with investors).

In the context of the Act, Funding Circle suggests either narrowing the definition of compensation as codified in Section 4(b) of the Securities Act and interpreted by the SEC or extending state securities law preemption to Rule 506 offerings even where limited forms of compensation are involved. The latter suggestion holds greater appeal because it limits any unintended consequences that may accompany redefining “compensation” – a definition found throughout federal securities regulation. Absent state securities law preemption, securities offerings will vary by state, thereby promoting greater fragmentation and inefficiency in forming capital for promising businesses.

The main service and value added by crowdfunded lending marketplaces is their ability to match lenders to borrowers. The secret sauce of each company in the ecosystem comes from not only the innovative or otherwise proprietary underwriting process of the loan, but also the company’s ability to source creditworthy borrowers. For this service, the company’s business model typically relies on an origination fee (paid as a percent of capital raised for a borrower).

Funding Circle believes in full transparency to both borrowers and investors: the only fees we charge are an origination fee to the borrower to compensate for the underwriting process as well as the matching of investors, and a servicing fee paid by investors to cover the costs of servicing a loan. As mentioned above, under the JOBS Act, any origination fee would likely constitute “compensation” in a securities sale and, therefore, would render debt originators subject to state securities laws. If compelled to choose between charging origination fees and the regulatory burden associated with state securities law compliance, companies may be incentivized to generate revenue through less transparent means.

We offer these suggestions as a mechanism for better facilitating debt crowdfunding – our suggestions in this testimony are neither exhaustive nor comprehensive. Instead, we hope to shine a light on ways to consider amending the JOBS Act to strike a better balance between functional viability and investor protection – and to do so in such a way as to reduce significant legal and compliance costs associated with crowdfunding as practically stipulated under the Act. Through its requirements, the Act should guide portals seeking to help small businesses form

capital from investors to do so in a manner that is both sustainable and adequately protects investors – but these requirements must achieve this objective without undermining the very impetus for change that gave rise to the Act. We hope that working together with lawmakers and regulators, we can help find a better path for the millions of small businesses who so desperately need access to capital. Anything less will be a significant missed opportunity.

Before closing, I next direct the Committee’s attention to why Funding Circle and certain other marketplace lenders who offer term credit differ substantially from other alternative credit providers that have otherwise been filling the small business lending gap, and how we as an industry are organizing around more sustainable lending practices.

Self-regulation in the Small Business Lending Market

Funding Circle is not alone in our growing concerns about the impact that the gap in access to small business credit is having in our country. In particular, this gap has allowed a category of high-rate and non-transparent lenders to seep into the market. In response to this trend, we are committed to working with other marketplace lenders, other responsible credit providers such as CDFIs and small business advocacy groups to architect certain industry standards that we hope will eliminate, or at least, discourage some of the more abusive practices that riddle the small business lending market.

While we expect those industry standards to cover a broad spectrum of issues and practices encompassed by responsible lending, lack of transparent pricing (including hidden fees, prepayment penalties, etc.) stand out as a particularly illustrative example of how Funding Circle continues to differentiate from many other lenders. We prominently disclose total and periodic costs of the loans we offer in an easy-to-understand and timely manner. This disclosure includes annualized interest rate, our origination fee and both the monthly and total repayment amounts. As a result, a small business owner can evaluate the true cost of credit and make an informed borrowing decision. In contrast to these relatively simple transparency measures, merchant cash advance and cash flow loan providers oftentimes quote financing costs as a factor rate or buy rate and rarely, if ever, provide an equivalent annualized interest rate -- even if asked. In addition, they often charge hidden or otherwise opaque fees, which are added to the cost of financing. Finally, such lenders often use fixed repayment schedules, where the same full repayment amount is due regardless of when the small business actually repays the advance or loan. In these cases, a credit provider may advertise “no prepayment penalty” even in a credit arrangement where prepayment would not reduce the total amount charged to the borrower.

As banks have continued to shift away from small business lending, American small businesses without adequate non-bank financing options remain vulnerable to the confusing, misleading, or, even worse, predatory lending practices common among short-term, high-rate lenders. In need of capital, small business owners will continue to enter into these short-term credit arrangements

with payments that they cannot afford or onerous terms which do not allow them to operate effectively let alone grow. If this issue sounds familiar, that's because it is: consumers historically faced similar issues in payday lending and regulators rightly linked high rates of default and re-borrowing in payday lending to consumer debt traps. Similarly, in small business credit, short-term loans with very high interest rates, especially where credit providers collect payments through access to the small businesses' sales or deposit account, are much more likely to result in debt traps. At Funding Circle, we align our success with the profitability and success of the small businesses to which we lend. We extend credit to businesses only where we have a high expectation of repayment. Our technology-enabled credit processes balance speed with rigor. Being data-driven and using credit algorithms does not require jettisoning all traditional indications of creditworthiness such as a debt service coverage ratios, asset coverage ratios, or credit history. Our online application and advanced analytics deliver an efficient borrower experience while still pricing risk appropriately, so that we do not have to rely on excessive interest rates or high fees to offset poor performance across our loan book. Instead, the very transparency and simplicity of our product helps ensure that only borrowers who should be able to repay take out one of our loans.

As mentioned above, Funding Circle is committed to collaborating with other marketplace lenders, responsible credit providers and small business advocates to promulgate certain industry standards in small business financing in the US. In the UK, Funding Circle worked closely with other industry leaders, Zopa and RateSetter, to launch the *Peer-to-Peer Finance Association* as a self-regulatory body for the sector to promote high standards of conduct and consumer protection.⁷ Along with other Association members, we worked closely with the Financial Conduct Authority to enact balanced legislation in the UK that would protect both investors and borrowers while also catalyzing important future growth in the industry.

Supporting marketplace lending represents a critical opportunity for policymakers to participate in paving the way for innovation to improve small business owners' access to affordable credit. But that support requires that policymakers truly listen to small business owners and understand their capital access needs. Marketplace lenders, such as Funding Circle, have already demonstrated an ongoing commitment to connecting supply – investor capital – and demand – term credit for small businesses – in a highly ethical, transparent and sustainable way.

Conclusion

Thank you for the opportunity to present this assessment for the Committee's review. At Funding Circle, we are striving to build a better financial world by building a transparent, market-driven approach that delivers much-needed capital to great American small businesses while at the same time allows investors to earn strong risk-adjusted yields. We hope that these ideas provide a framework for considering how to further refine existing laws and policy

⁷ For additional information on the Peer-to-Peer Finance Association in the UK, see <http://p2pfa.info/>.

measures so that there is an even playing field between marketplace lenders such as Funding Circle and older-line lenders who are unable to deliver capital to small businesses who use it to expand and grow. This exciting segment of the market has already taken great strides in the past decade, and we anticipate even great growth in the years to come: our strong belief is that this will be beneficial for small business, for investors, and for our country as a whole.