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Testimony Submitted by

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On behalf of the

Commercial Finance Coalition

before the

House Committee on Small Business

Subcommittee on Economic Growth, Tax, and Capital Access

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Thank you for the opportunity to present testimony on behalf of the Commercial Finance Coalition ("CFC"). The CFC is comprised of responsible finance companies that provide needed capital to small businesses through innovative methods. Our members also include select vendors that provide technology services to the small business finance industry.

CFC member companies offer fair and innovative alternatives to bank term loans and have stepped in to provide capital to small businesses when larger, traditional banks stopped providing such financing. CFC member companies primarily offer Merchant Cash Advance ("MCA") factoring products. An MCA allows small businesses to access funds for, as an example, a seasonal inventory surge or to replace an unexpected major equipment failure. CFC members provide financing between $10,000 and $500,000 to qualified small businesses.

CFC member companies help meet the needs of American small business entrepreneurs. CFC member companies provide financial flexibility for small business owners who lack the daily capital to expand their businesses or weather difficult financial circumstances. By selling future receivables to MCA companies, these business owners can meet their capital needs, hire new employees, and create jobs in today's economy.

The CFC believes that small businesses should have choices in the financial marketplace. The CFC works to unite responsible finance companies in our efforts to educate Congress, federal and state regulators, and state elected officials about the non-bank commercial finance industry. Small businesses face a gap in credit availability. CFC member companies are trying to close the gap and help spur entrepreneurship so more Americans can own and operate their own businesses.

<u>Small Businesses Need Choices</u>.

Small businesses benefit from having different types of financing available. A business owner who is planning for long-term capital needs may choose to apply for a loan guaranteed by the Small Business

Administration ("SBA"). These SBA loans are relatively low-cost and typically range from $25,000 to $5 million. The applicant typically must submit a business plan[1] and the business owner often must use her house as collateral for the loan.[2] A business owner who has short-term capital needs may choose to apply for a loan from a non-bank lender or apply to sell future receivables to an MCA company. These types of transactions are typically higher-cost and are in smaller dollar amounts. The applicant typically must submit bank statements showing several months of revenue, and the business can receive funds in a matter of days.

Whatever the type of financing a business owner chooses, banks alone are not addressing the needs of small businesses. Other financing sources are finding success because small businesses demand them. This demand shows that they are being underserved by the "traditional" funding sources.

The Landscape of Financing Options Available to Small Businesses

Traditional Lending – Despite their decline in issuance, traditional bank loans remain the primary source of financing for small businesses, in part due to familiarity.[3] Banks often form relationships with their small business customers and have been willing to underwrite loans.[4] The structure of traditional lending tools also has its advantages. Small businesses can carefully compare readily available loan terms against other loans, and the loans involve a defined maximum cost to the business. Traditional loans often involve flexible repayment terms (e.g., 3-10 years), can be obtained for higher-dollar amounts than other financing tools, and are not always secured by collateral. Moreover, guarantees from the SBA provide additional security for banks, enabling more small businesses to access traditional lending.

Nevertheless, traditional lending suffers from certain deficiencies, making it inaccessible or impractical to some small businesses. As a threshold issue, qualifying for a traditional bank loan can be an onerous task for many small businesses. Small businesses often do not have the required audited financial statements or assets that can be pledged as collateral.[5] The ideal loan applicant would have a lengthy history of

[1] The SBA provides a 37-page guide to help loan applicants prepare a business plan. *How to Write a Business* Plan, U.S. Small Business Administration, *available at* https://www.sba.gov/sites/default/files/How%20to%20Write%20a%20Business%20Plan.pdf.
[2] *See Loan Fact Sheet*, U.S. Small Business Administration, *available at* https://www.sba.gov/sites/default/files/SBA%20Loan%20Fact%20Sheet%20(San%20Diego%20District).pdf.
[3] *2015 Small Business Credit Survey*, Federal Reserve Banks of New York, Atlanta, Cleveland, Philadelphia, St. Louis, Boston, and Richmond, March 2016, *available at* https://www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf.
[4] Karen Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation* (November 29, 2016), Harvard Business School Entrepreneurial Management Working Paper No. 17-042; Harvard Business School General Management Unit Working Paper No. 17-042, *available at* SSRN: https://ssrn.com/abstract=2877201 or http://dx.doi.org/10.2139/ssrn.2877201.
[5] Brainard, Lael, *Community Banks, Small Business Credit, and Online Lending*, Board of Governors of the Federal Reserve System. September 30, 2015, *available at* https://www.federalreserve.gov/newsevents/speech/brainard20150930a.htm.

profitable performance, but the reality is that many small businesses have short histories or a mixed track record of profitability.[6]

The risks associated with traditional lending make it impractical for some small businesses as well. Because loans are absolutely repayable, the assets of the business—and sometimes the business owner's home—are at risk, and default can force a small business into bankruptcy.

Lenders are equally concerned about risk. In an environment where regulators heavily scrutinize banks, lenders are increasingly cautious about extending debt. As a result, banks have increased collateral requirements, reduced the amount available for borrowing, and reduced the pool of small business borrowers deemed creditworthy. Ninety percent of loans under $100,000 were secured by collateral in 2013, up from 84 percent in 2007.[7] In addition to the regulatory risks, banks may be less willing to issue smaller business loans, because the underwriting costs for banks to scrutinize a potential borrower's financial records and business plan are about the same regardless of whether the loan application is for $2 million or $20,000.[8]

Even qualified borrowers have difficulty finding willing lenders in a reasonable timeframe. According to a survey conducted by seven Federal Reserve banks, the average small business owner spends 24 to 72 hours talking to lenders, filling out loan applications, and submitting documentation.[9] This survey further suggests that some borrowers were willing to pay a higher price in exchange for an easy application process, a quick decision, and rapid availability of funds.[10]

"Fintech" Lending – Fintech lending includes non-traditional lending that directly addresses some concerns of small businesses by providing faster access to capital than traditional lending. Compared to the lengthy process of finding a traditional loan, business owners can quickly shop lenders on the internet, apply for a loan, and receive a decision in as little as an hour.[11] Technology has allowed lenders to automate the lending process, leading to a less burdensome application process. Algorithms allow fintech lenders to render rapid decisions on applications, often considering information from a wide range of sources that are not typically involved in bank underwriting of loans (e.g., data on online banking, accounting, bookkeeping, credit cards, and social media).[12] The existence of fintech lenders provides small businesses with the ability to quickly obtain capital needed for immediate operations.

Non-traditional loans are not without their disadvantages. For instance, some borrowers may not be as familiar with the lending products. Additionally, although some small businesses reported a willingness

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[6] *Id.*
[7] Wiersch, Ann Marie & Scott Shane, *Why Small Business Lending Isn't What It Used to Be* (August 14, 2013), Economic Commentary (Research Department of the Federal Reserve Bank of Cleveland).
[8] Stacy Crowley, *Online Lenders Offer a Faster Lifeline for Small Businesses*, N.Y. Times, April 8, 2015.
[9] *Supra* note 1.
[10] *Id.*
[11] Cowley, *supra* note 6.
[12] Brainard, *supra* note 3.

to pay a higher price in exchange for the convenience of alternative products, one report suggests that the average annual cost of borrowing tends to be higher than the costs associated with traditional bank products.[13] Small business borrowers may not fully understand the terms of the loan, and much like traditional loans, default can place the entire business at risk.[14]

Factoring – Factoring is the purchase of invoices at a discount. Factoring has been used by businesses to obtain financing for hundreds (perhaps thousands) of years.[15] In a factoring transaction, a small business that sells goods and services to a customer can then sell the invoice from the sale to a finance company called a "factor." The invoice is typically payable within 30 to 60 days. The factor pays upfront and buys the invoice at a discount, allowing the small business to obtain the cash quickly. The factor takes the credit risk that the small business's customer cannot or will not pay the invoice.

Merchant Cash Advance – MCA is a specific form of factoring. It involves a business selling a fixed portion of its future receipts to an MCA company in exchange for money upfront.[16] Under these agreements, the business does not promise—and is not required—to repay the MCA company.[17] Instead the business delivers the receipts that it sold to the MCA company as the business earns those receipts.[18] The receipts are purchased by the MCA company at a discount to cover the MCA company's expenses and to compensate the MCA company for assuming risk. The risks taken by the MCA company are significant. If the business fails to earn revenue, the MCA company is not owed anything under the agreement, so long as the business has not breached the agreement.[19]

For example, if an MCA company purchases $10,000 of a small business's future revenue and agrees to receive 10% of the small business's future revenue until the $10,000 is received, the transaction would be completed whenever the small business succeeded in getting $100,000 of cumulative revenue. This milestone could be achieved in a month, a year, or never.

The Advantages of MCA – MCA has many advantages for small businesses. MCA injects funds into a business without the business incurring debt, as the agreements do not contain an obligation of repayment.[20] MCA has transparent costs for the small business: the MCA company will receive the amount of revenue that it purchased from the business. The incentives of the MCA company and the business are aligned because the MCA company's compensation is contingent on the continued success

[13] *Id.*
[14] *Id.*
[15] David B. Tatge, *et al.*, *American Factoring Law* 4-8 (2009).
[16] *See, e.g.*, *K9 Bytes, Inc. v. Arch Capital Funding, LLC*, 57 N.Y.S.3d 625 (Sup. Ct. N.Y., Westchester County, May 4, 2017).
[17] *See IBIS Capital Group, LLC v. Four Paws Orlando LLC*, 2017 NY Slip Op 30477(U) (Sup. Ct. N.Y., Nassau County, March 10, 2017) (discussing factors used to distinguish between loans and merchant cash advance agreements).
[18] *See K9 Bytes, Inc.*, 57 N.Y.S.3d at 632-34.
[19] *See id*.
[20] *See id.*

of the business.[21] Addressing a key concern with traditional financing, MCA companies quickly fund businesses by offering efficient and timely underwriting.[22] Additionally, in MCA, the business owner does not enter into a partnership or give up control of the business.

MCA, however, is not suitable for businesses at every stage of development. MCA depends on the future revenue of the business and is generally provided to companies that already have a proven source of revenue. Startups that do not expect substantial revenue for an extended time would not be ideal candidates for MCA.

Equity and Partnership – The Subcommittee focuses on fintech financing and online lending, but equity financing provides small businesses another avenue for funding. Small businesses can receive funding by entering into partnership agreements or by selling a portion of the company to investors. These agreements have the advantage of providing funding for the business without the business incurring debt. Equity funding, however, is not readily available for all businesses, with venture and angel capital making up less than 2% of small business financing in 2016.[23] Also, even when equity funding is available, the business owner must limit potential gains by relinquishing a share of the business. Moreover, depending on the agreement between the parties, the business owner may risk giving up control of the business itself.

Existing Regulation is Sufficient to Protect Small Businesses

The MCA and commercial lending spaces are sufficiently regulated by existing federal and state laws and regulations. Both MCA companies and commercial lenders must comply with laws and regulations affecting nearly every aspect of their transactions, from marketing and underwriting through servicing and collection. Even if they comply with every applicable law and regulation, small business financers must also be wary of the Federal Trade Commission's ("FTC's") powerful authority to prevent unfair or deceptive acts or practices.

For example, at the federal level, the Fair Credit Reporting Act ("FCRA") and its implementing Regulation V, which govern entities in the consumer reporting industry, including consumer reporting agencies, users of consumer reports, and furnishers of consumer information, apply to business-purpose transactions. The FCRA generally protects individuals, regardless of the purpose of the transaction, including by requiring a financer to have a permissible purpose to pull a consumer report for a sole proprietor or for an individual guarantor of a business's transaction.[24] This is particularly relevant in the

[21] *See id*.
[22] *Opportunities and Challenges in Online Marketplace Lending*, p. 13, United States Department of the Treasury (May 10, 2016), *available at* https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.
[23] *Frequently Asked Questions About Small Business Finance*, U.S. Small Business Administration (July 2016), *available at* https://www.sba.gov/sites/default/files/Finance-FAQ-2016_WEB.pdf.
[24] *See* 15 U.S.C. § 1681a(c) (defining "consumer" as an individual).

world of small business finance, where the business is often organized as a sole proprietorship, or an individual owner will serve as guarantor in the event of default by the business. Additionally, the FCRA requires a user to provide notice to an individual if it takes adverse action on the basis of information contained in a consumer report on the individual.[25]

Additionally, the Telephone Consumer Protection Act[26] and the CAN-SPAM Act[27] restrict certain telephone and email communications and apply to business-purpose transactions.

Moreover, Section 5(a) of the Federal Trade Commission Act gives the FTC broad enforcement authority to prevent unfair or deceptive acts or practices ("UDAPs") over a wide range of entities, including MCA companies and commercial lenders.[28] The FTC wielded its authority to protect small businesses as recently as 2014, when it entered into a consent order with a company that leased payment processing devices to small businesses.[29] The authority to prevent UDAPs is an extremely powerful tool in the FTC's arsenal, giving it the ability to target entities that may be technically complying with the law but are engaged in otherwise harmful practices.

Commercial lenders also must comply with the Equal Credit Opportunity Act ("ECOA") and its implementing Regulation B. ECOA and Regulation B prohibit discrimination against protected classes of people in the extension of credit, apply to business credit, and provide protections specifically for business borrowers.[30]

Finally, many states require a license to make a loan to a business, limit the interest rates lenders may charge to business borrowers, or both.[31] With a licensing scheme comes state regulator supervision. States that regulate lending also typically limit the terms of loans, require disclosures in loan documents, and limit the fees that creditors may impose. Most state laws regulating lending apply to loans with smaller dollar values, exactly the types of loans upon which small businesses rely.

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[25] 15 U.S.C. § 1681m(a).
[26] 47 U.S.C. § 227.
[27] 15 U.S.C. §§ 7701 *et seq.*
[28] 15 U.S.C. § 45(a).
[29] *Federal Trade Commission v. Merchant Services Direct, LLC*, Case #: 2:13-cv-00279-TOR (E.D. Wa. 2014), *available at* https://www.ftc.gov/system/files/documents/cases/141125merchantstip.pdf; *see also*, "Press Release: FTC Charges Marketers with Deceiving Small Businesses into Buying Credit/Debit Card Processing Services and Equipment" (July 30, 2013), *available at* https://www.ftc.gov/news-events/press-releases/2013/07/ftc-charges-marketers-deceiving-small-businesses-buying.
[30] 12 C.F.R. § 1002.9(a)(3). Protected classes include: Race, color, religion, national origin, sex, marital status, age, exercising rights under the Consumer Financial Protection Act, and deriving income (some or all) from a public assistance program. *See* 12 C.F.R. § 1002.1(b).
[31] *See, e.g.,* Or. Rev. Stat. § 82.010(3)(a) (imposing a specific interest rate limit on business-purpose loans); Cal. Fin. Code §§ 22009(a), 22100(a) (requiring a license to make business-purpose loans); Ala. Code §§ 5-18-4(a), 5-19-3(a), 5-18-15(a) (requiring a license to make loans of any purpose, and limiting the interest rates that a licensee may charge for loans of any purpose).