

Testimony of

William Phelan

President and Co-Founder, PayNet, Inc

Before the

**United States House of Representatives
House Committee on Small Business**

Hearing on

**Financing through Fintech: Online Lending's Role in
Improving Small Business Capital Access**

October 26, 2017



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Overview

Post financial crisis of 2009 clearly resulted in disruptions in the credit market for small businesses as traditional sources of credit like community, regional and large banks could no longer profitably supply credit or they were preoccupied with other more pressing issues in their businesses. Partly due to the JOBS Act and partly due to new applications of technology, innovators in the form of fintechs invented new ways to provide credit to small businesses to fill this “credit gap”. Fintechs have faced the challenge of building systems for sourcing borrowers, finding the capital to make loans and building the technology platforms to lower the cost of processing a credit application. They have excelled at building technology platforms to lower the cost of providing credit applications to small businesses but as a group, they still face high costs to find prospective borrowers and they face high costs of capital as a source for their loans. I note that since the dawn of fintech, several have decided to exit this market or they have gone out of business themselves.

It is clear that fintechs have not fully realized the potential they held several years ago when many equity analysts predicted fintech would transplant banks as a primary source of credit to small businesses. But fintechs have provided three critical benefits to the supply of credit to small businesses: first, they have figured out technology platforms to lower the cost of processing a credit application; second, they have changed the expectations among small businesses for access to and speed for working capital credit, which traditional sources cannot afford to offer at a reasonable cost; third, they are filling the credit gap faced by small businesses across the credit spectrum and industry sectors. More work must be done by these innovators to improve their business models and I note that many fintechs are themselves small businesses.

Improvements in fintech business models include cheaper sources of capital that can be the source for lower priced loans. Another major improvement necessary for fintechs to become a long term source of credit for small businesses is to lower the cost to acquire their customers who are the prospective business borrowers. Also, many fintechs are addressing the capital and customer acquisition business issues through partnerships with banks. Most importantly, they must continue to work on their business methods to provide transparency, such as that provided by the ILPA through its SMART Box, on the terms of loan contracts with small businesses. Like any market of suppliers, lenders to small businesses provide varying degrees of information about their product to ensure their loan contracts are fit for the intended purpose. My concern is that fintech, in its early stage of development, could fail as an industry to fill the credit gap. This failure could result from lenders who do not fully inform borrowers on the terms of their loan contracts and in doing so, create the impression that all fintech lending is an

untrustworthy source of credit. This could drive away other lenders that are providing better disclosure about the terms of their contracts and seeking to lower the cost of delivering credit to small businesses. In this scenario of market failure, less supply of credit becomes available for small businesses and further enlarging the credit gap.

Introduction and Purpose

Members of the Committee, my name is William Phelan, President, and Co-Founder of PayNet, Inc. based in Skokie, Illinois, a suburb of Chicago. I appreciate the opportunity to speak today on behalf of PayNet, Inc. which provides small business credit information to banks, commercial finance, alternative lenders and corporate credit lenders throughout the nation. PayNet, Inc. is a member of the U.S. Chamber of Commerce and I am active on a number of boards in addition to my role operating PayNet on a day to day basis. My board participations include The Canadian Leasing and Finance Association (CFLA), The Innovator Lender's Platform Association (ILPA). I was formerly on one of the Advisory Boards for the Chicago Federal Reserve Bank and for the Equipment Leasing and Finance Association (ELFA). I speak regular at industry events and in the business community on the topic of access to credit for private companies in the U.S. and Canada. My role today is to provide a perspective and impact of fintech on credit and capital availability to the small business economy.

Background

Access to small business credit information increases access to capital, spurring economic growth and jobs, and significantly reduces the cost of doing business. PayNet collects and tracks this data on small business loans from hundreds of U.S. and Canadian lenders each month, turning it into actionable intelligence.

PayNet, Inc. maintains a repository of historical payment information on small business loans; collecting real-time small business loan and lease information from more than 300 leading U.S. lenders. PayNet's data provides a unique window into the world of small business lending/credit trends compiled from our "real-time" proprietary database consisting of over 24 million term debt contracts worth nearly \$1.5 trillion in loan value.

Key statistics about the PayNet Database are as follows:

- Average number of months of history per lender is 117.
- Database contains nearly \$1.5 trillion in financial obligations.
- Average transaction size per contract is \$67,056.
- Average term per contract is 3.7 years.
- Average monthly payment per contract is \$1,524.

Small Business Credit

Small businesses in America are a primary driver of economic growth and have become the centerpiece of the economic recovery. According to the U.S. Small Business Administration's Office of Advocacy's most recent estimate, 29.6 million businesses operated in the U.S. in 2014.

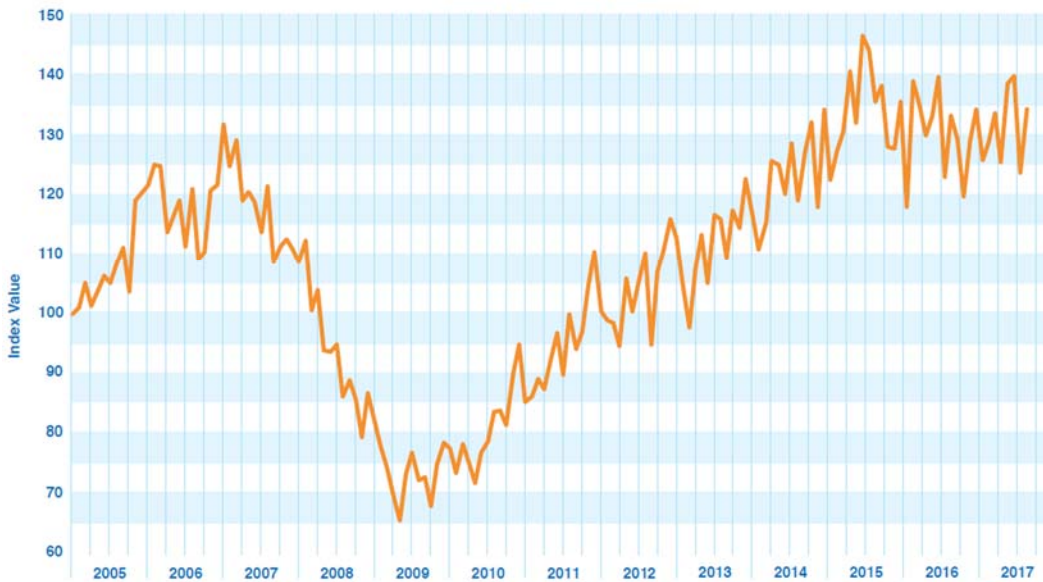
The perplexing aspect of the small business economy is not its importance as the engine of U.S. growth, innovation, and competitive edge, but how little we know about this important economic engine. Limited knowledge hinders the ability of bodies such as this Committee to create policies that help small businesses.

Much interest exists now to better understand the small business credit market. This interest is driven in part by research showing the credit gap exists in the form of disruptions of credit access to small businesses. Research shows this credit gap has been shown to restrict economic growth and wage growth. While difficult to predict with exact science, the impact of the credit gap has most likely contributed to what many consider to be sub-par growth of less than 3% in the U.S. GDP over the past several years. Disruptions in the market mechanism that operated and provided credit to small businesses pre-recession are one likely cause of this gap, as big banks pulled out of local markets and community banks consolidated their operations and focused on meeting compliance requirements.

Small Business Credit Conditions

The August 2017 Thomson Reuters/PayNet Small Business Lending Index (SBLI), which measures the volume of small business loans issued over the past 30 days, increased 8% to 134.2 in August 2017 from 123.8 in July 2017. Compared to August 2016, the SBLI increased 1%.

Thomson Reuters/PayNet Small Business Lending Index (SBLI)
(January 2005 - August 2017)

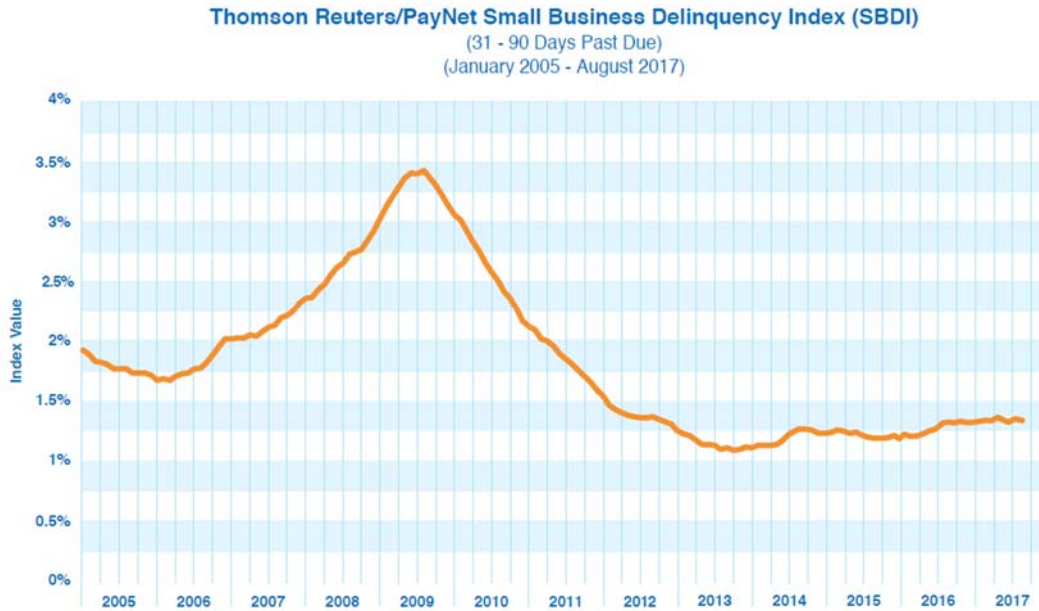


Top growth sectors driving investment expansion by small businesses were found in the Construction (+6%), and Accommodation & Food Service (+6%) businesses which together represent over 13% of the small business economy. Arts, Entertainment & Recreation (+10%) remained the top growing sector among small businesses. In a big turnaround, Mining (+3%) and Wholesale trade (+3%) were both positive for the first time in the last several years.

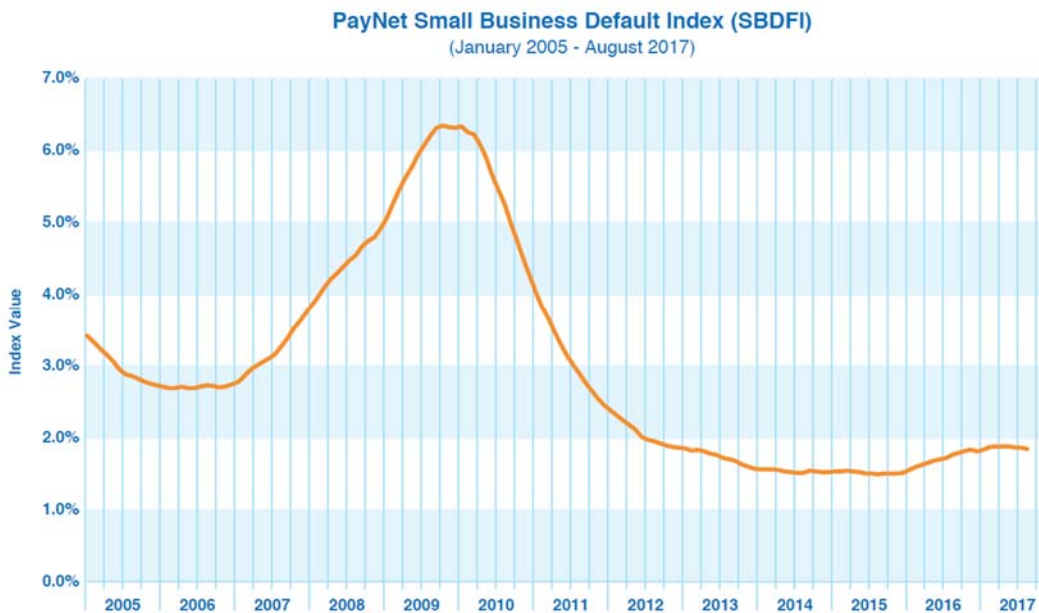
After many months of double-digit contractions, growth in the Health Care sector stabilized dramatically, and has been slightly positive in recent months with a 0.2% increase.

Similar to last month, growth continued to be strongest in the Western Part of the South as well as the eastern part of the Midwest, likely reflecting in part the acceleration in global growth this year and the regions' exposure to globally-oriented industries such as mining and manufacturing, respectively. Additionally, the Pacific portion of the west coast is starting to show material signs of strength in the most recent couple of months. The mid-Atlantic is the one region of the country where contractions continue to persist with little signs of abatement, although the most recent results were somewhat positive.

The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI) 31-90 days past due, which measures the percentage of loans that are delinquent, decreased to 1.33% in August 2017 from 1.35% in July 2017. Compared to one year ago, delinquency increased by 1 basis point (bp). Transportation showed a 10 bp decrease in delinquency. Increases in delinquency are shown in both Agriculture (2 bps) and Construction (1 bp).



The PayNet Small Business Default Index (SBDFI), which measures the percentage of loans and leases to small businesses that have defaulted, at 1.84% is 35% below pre-crisis readings, and has been receding in recent months.



Much of the improvement in recent months has come from two formerly high-risk sectors experiencing lower default rates. Mining default rates have declined approximately 1%-point

over the last year, and Transportation default rates have been declining at a 0.6% annualized rate over the last three months. Conditions are in place for small businesses to drive GDP growth resulting from exceptional financial health.

Most other sectors, with the exception of Agriculture, have current default rates that are around 25% to 75% below pre-crisis levels. Information Services continues to show a dramatic deterioration in default rates in recent months, but no other sector has seen its default rate rise at even a 0.4%-point annualized rate over the last three months.

Similar to originations trends, default rates are currently declining rapidly in the Western part of the South. In fact, they have been declining at a nearly 1%-point annualized rate in that region over the last three months. Despite these recent improvements, however, the region's default rate stands 80 basis points above the next closest region.

Many other regions with exposure to globally-oriented sectors, such as the Midwest and the Mountain portion of the West Coast, have also been experiencing stabilizing or declining default rates in recent months. By contrast, some deterioration in financial conditions is present in both the Northeast as well as the Pacific portion of the West Coast. Default rates remain lowest in the New England region and the Midwest generally.

Credit conditions for small businesses in 2017 indicate less investment for growth but higher financial quality compared to pre-financial crisis. We see in the data that growth rates nearing 12% for the period 2005-2007 versus -1% for the period 2015-2017. While investment growth remains tepid, financial health stands stronger than the pre-financial crisis period. The net result shows that small businesses as a group remain reluctant to invest in growth projects at a time when their financial health has improved.

Market Size Estimates

The small business lending market is vast. According to the FDIC, there were \$180 billion in business loan originations under \$250,000 in the United States in the fourth quarter of 2014, across 22.1 million loans. Oliver Wyman estimates the potential for \$80 to \$120 billion in unmet demand for small business lines of credit, and we believe that there is also substantial unmet demand for other credit-related products, including term loans. We also believe that the application of technology to credit assessment can expand the total addressable market for small business credit.

In 2013, the Federal Reserve estimated gross shadow banking liabilities in the U.S. (their measure of non-bank credit intermediation) at roughly \$15 trillion, down 30% from a peak of \$22 trillion in 2007 (vs. bank liabilities growing from \$14 trillion to \$16 trillion over the same period). The contraction of shadow banking liabilities is not surprising considering that the Fed's

broad definition includes all structured credit (including asset backed securities now consolidated on bank balances following accounting rule changes), as well as commercial paper, repo and money market mutual funds. Additionally, during the financial crisis, several of the largest non-banks (particularly the investment banks) converted to Fed-regulated bank holding companies, further reducing the shadow bank universe. (“The Future of Finance, The Rise of the New Shadow Bank”, Ryan M. Nash and Eric Beardsley, Goldman Sachs, Equity Research, March 3, 2015.)

PayNet analysis offers another view of the small business credit market with estimates of the size of the credit markets in the commercial finance, commercial bank, and alternative lender segments. The analysis was conducted for two segments: facilities up to \$1 million and up to \$250,000.

<u>Segment</u>	<u>Balance (\$Bil)</u>		<u>Contract Count (Thou)</u>	
	<u>\$250k and Under</u>	<u>\$1mil and Under</u>	<u>\$250k and Under</u>	<u>\$1mil and Under</u>
Commercial Finance	\$ 169	\$ 242	6,760	7,070
Commercial Bank *	\$ 311	\$ 695	26,550	27,710
Alternative Lending (2016)	\$ 6	\$ 7	180	180
Total	\$ 481	\$ 944	33,490	34,960

*Agriculture and Farmland Loans only go up to \$500K in the FDIC data

For the larger \$1 million and under segment, the analysis shows an estimated \$944 billion in outstanding loan amounts in these three segments of the market. Based on this market size this equates to over 35.0 million financial contracts. For the \$250,000 and under segment, the analysis shows an estimated \$481 billion in outstanding loan amounts. Based on this market size this equates to over 33 million financial contracts.

Given that the SBA has estimated that other sources of capital such as mezzanine and buyout, angel capital, and venture capital have comprised approximately 13% of the total small business financing in recent years, the total small business financing market could equal approximately \$1.1 trillion.

While credit unions do not have readily accessible breakouts of their business loans by deal size, business loans represent approximately \$74 billion in outstanding value as of June 2017, presumably a material share of which fits into the small business category. Small business lending grew by 130% between mid-2007 and the end of 2015 according to CUNA Vice President Mike Schenk.

As data on small business lending remains elusive, we used various methods to size this market, which are detailed in the appendix at the end of this testimony. Regardless of the assumptions

used, however, it is clear that the small business credit market represents a sizeable proportion of the US economy and one that is integral in driving growth and prosperity.

The Small Business Credit Market Mechanism

The market mechanism by which small businesses access credit consists of commercial lenders and businesses that finance the purchase of their goods and services. Commercial lenders and businesses employ various methods to provide credit to small businesses. Small business lending has historically been expensive because of its diversity and loan size. Corporate credit underwriting requires 28 separate tasks to arrive at a decision. These 28 tasks involve collecting information for the credit application, reviewing the financial information, data entry and calculations, industry analysis, evaluation of borrower capability, capacity and valuation of collateral. A time series analysis of these steps reveals a 2-3 week process at best and in some cases as much as eight weeks to arrive at a single credit decision. Three major departments of the bank play a role in the process – relationship manager, credit analyst, and credit committee.

Costing out this process shows a cost of \$4,000 to \$6,000 to underwrite each credit application. With these costs, banks are unable to turn a profit on this business unless the loan size exceeds \$500,000. The following chart shows these costs in detail:

Table 1: Corporate Credit Underwriting Cost per Application

MANUAL PROCESS			
People	Task	Time (hrs)	Total Cost (\$)
Loan Officer	Credit Application	5.8	\$414.66
Credit Analyst	Reviews	19.0	\$1,196.15
Credit Analyst	Data Entry and Calculations	46.0	\$2,803.85
Credit Analyst	Industry Risk Analysis	16.0	\$1,323.08
Credit Analyst	Borrower capability	2.0	\$115.38
Credit Analyst	Valuation and liquidity of collateral	10.0	\$726.92
Total		98.8	\$6,994.71

There is nothing wrong with this corporate credit underwriting process for large middle-market and corporate lending, but when it is applied to smaller commercial credit, it clearly works as a disincentive to the bank and to the loan officer.

Loan review is another process that has made commercial lending unattractive because it adds a significant scope of work to credit administration. An effective loan review program provides senior management and the board of directors with a timely and objective assessment of the

overall credit quality of the portfolio. Appropriately grading loans enables the bank to take timely steps to minimize credit losses. Similarly, it is important to identify trends that affect the collectability of loans in the portfolio and recognizing segments of the portfolio that are or have the potential to become problem areas.

The key to an effective loan review system is accurate loan classification or credit grading. Here again, the typical corporate credit process makes accurate risk ratings a major challenge for banks because of the sheer number of credits in a robust commercial lending business. Analysis shows that one loan review involves 15 separate steps, from collecting and spreading financial statements to conducting cash flow analysis and adjusting risk ratings. Three major departments are involved in this process, including the lending group, credit and audit groups. A single loan review can take a bank up to two days of work to complete at a cost of over \$1,000 as shown below:

Table 2: Loan Review Cost per Customer

People	Task	Time (hours)	Internal Costs (\$)	External Costs (\$)	Cost (\$)
Loan Officer	Department Total \$ / App	7.75	\$ 372.60	\$ 250.00	\$ 622.60
Credit Analyst	Department Total \$ / App	4.00	\$ 153.85	\$ 100.00	\$ 253.85
Administration	Department Total \$ / App	4.00	\$ 153.85	\$ -	\$ 153.85
Sales	Department Total \$ / App	1.50	\$ 57.69	\$ -	\$ 57.69
Totals		17.25	\$ 737.98	\$ 350.00	\$ 1,087.98

This means that a bank with 1,000 commercial customers will incur over \$1 million in costs to conduct annual loan reviews. In some cases, regulators are requiring more frequent reviews which can double the cost, even as banks are trying to cut costs to boost profitability.

The Credit Gap

One key feature of the market mechanism has been community banks that operate in local markets through a high touch business model. The consolidation of community banks has most likely stood as one cause of the credit gap. The number of community banks has shrunk by more than a third since 2007. Anecdotally we find that community banks are concentrating on loans with a minimum value of \$500,000 or more because smaller balance loans are not profitable.

A recent study quantifies how a sharp downturn in small business lending activity from the four largest banks in the US (Citi, Wells, JP, B of A) affected economic outcomes as well as how other

nonbank lenders responded to this sharp pullback in small business lending activity from the Big 4 Banks. (“The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets”, Brian S. Chen, Harvard University; Samuel G. Hanson Harvard Business School and NBER; Jeremy C. Stein Harvard University and NBER in March 2017).

The motivating statistic for this study was the fact that small business originations (less than \$1mil) for the Big 4 banks were just 50% of their 2006 level as late as 2014, which was only a small tick-up from the nadir in 2006 based on Community Reinvestment Act data. This was a far more severe decline than other banks’ pullback in the data set, which saw originations reach 80% of 2006 levels as of 2014. On average, small business lending fell 30% more at the Top 4 Banks than at other banks in the CRA database

The authors found Small business lending by the four largest U.S. banks fell sharply relative to other banks beginning in 2008 and remained depressed through 2014. They explored the consequences of this credit supply shock, with a particular focus on the resulting dynamic adjustment process. Using a difference-in-difference approach that compares counties where the Top 4 banks had a higher initial market share to counties where they had a smaller share, they found that the aggregate flow of small business credit fell and interest rates rose from 2006 to 2010 in high Top 4 counties. Economic activity also contracted in these affected counties: fewer businesses expanded employment, the unemployment rate rose, and wages fell. Moreover, the employment effects were concentrated in industries that are most reliant on external finance, such as manufacturing. They further explored how high Top 4 counties adjusted to this shock from 2010 to 2014. While the flow of small business credit has slowly recovered in affected counties—as smaller banks, non-bank finance companies, and online lenders have filled the void left by the Top 4 banks—loan interest rates remain elevated, suggesting that credit conditions are still tighter in these areas. Moreover, although the unemployment rate returns to normal by 2014 in high Top 4 counties, the effects on wages persist, suggesting that more expensive credit may have led small businesses to become less capital intensive which in turn suppressed productivity.

With the consolidation of community banks since 2007, the number of traditional loan sources for small businesses shrank 35%, contributing substantially to the small business credit gap. The community banks that are still in operation are going up-market to more profitable loans, with a minimum size of \$500,000, in response to increased capital requirements for higher risk loans and greater regulatory scrutiny. The time, paperwork and cost of more than \$5000 for a bank to even process a loan are factors causing a barrier between small businesses and their bankers.

Fintechs that use software, data, and analytics to deliver credit faster and with less paperwork are part of the emerging small business credit market providing new sources of capital.

Fintech Lender Business Overview

Marketplace lending is a new source and method for providing capital to businesses and consumers. It rose from the JOBS Act which authorized new methods to provide capital after the Great Recession. Providers of credit latched onto some of the concepts outlined in the JOBS Act as ways to access funding and to provide loans at low cost. The term marketplace refers to a broad category of companies that provide direct lending, peer to peer lending and referrals. Credit providers use a combination of technology, data and analytics and traditional credit systems, thus are often associated with the term “fintech,” to process loan applications at lower costs than a traditional underwriting process generally favored by banks. Size estimates for the credit market vary by source, but the general consensus among all is that marketplace lending will grow to become a substantial and established provider of credit for consumers and businesses over the next 5 years.

Fintech’s share of the small business lending market are generally estimated to be \$5B to \$7B of small business loans (“Alternative lending - Commoditizing loan applications through technology while paving the way for big data investing”, Ernst & Young, 2016). Fintech’s share of small business originations is estimated to grow to \$50B by 2020 (Business Insider - One area of US alt lending is recovering, Feb. 2017).

Morgan Stanley estimates the size of global marketplace lending can reach \$290 billion by 2020. They estimate a 51% CAGR through 2020 after growing at a 123% CAGR 2010-14. Most of this growth is estimated to occur in the U.S. and China. Morgan Stanley estimates marketplace lending will approach \$150 billion by 2020. Morgan Stanley estimates TAM of 184 Billion in outstanding loans with 100 Billion in unmet demand, SME marketplace lending represented \$4.6 Billion on 2014 and is expected to reach \$47 Billion or 16% of total US SME issuance in 2020, primarily on new credit expansion. This is a significant impact on addressing unmet credit demand for the SME segment.

LOAN TYPE	TOTAL MARKET (\$ billions)	2014 (\$ billions)	EST. GROWTH % 2020
Unsecured Consumer	\$450	\$7.4	47%
Small Business	280	4.6	47%
Student Loans	400	2.2	40%
Mortgages	1,000	14.0	na
Autos	250	1.6	na

Products and Terms

Products are traditional loans with non-traditional repayment. Loans are used by businesses to fund working capital and to buy equipment. Loan amounts are offered up to \$2 million but we

see the average around \$60,000 with the balance increasing. We see loan terms offered up to 5 years but the actual maturities average less than 1 year but term is increasing.

Most lenders offer fixed term loans. The principal amount of each term loan ranges from \$5,000 to \$2 million. The principal amount of the term loan is a function of the requested borrowing amount and credit risk assessment of the customer's ability to repay the loan. The typical term loan ranges from 3 to 24 months. Some lenders provide highly tailored loan terms to differentiate their product and meet the specific nature of many customers' borrowing needs. Term loans are repaid through fixed automatic ACH collections from their business bank account on either a daily or weekly basis. Term loans are originated directly or through issuing partners such as banks and loans that are purchased from the issuing banks have similar performance to internally originated loans.

Another major loan product is a revolving line of credit with fixed six-month level-yield amortization on amounts outstanding and automated weekly payments. These credit lines range from \$10,000 to \$25,000. A customer may be offered a line of credit based on the credit risk assessment of the customer's ability to repay the line of credit. Line of credit products are typically issued directly to borrowers, rather than through bank partners.

Several coalitions of fintech lenders have arisen to provide increased disclosure of their loan products to prospective small business borrowers. The Innovative Lenders Platform Association (ILPA) offers the SMART Box™ (Straightforward Metrics Around Rate and Total cost) to compare loan pricing and enhance disclosure standards. The SMART Box offers pricing metrics, calculators, and explanations to help small businesses understand and assess the costs of their small business finance options. Responsible Business Lending Coalition (RBLC), a network of for-profit and non-profit lenders, brokers and small business advocates offers The Small Business Borrowers' Bill of Rights. The Small Business Borrowers' Bill of Rights identifies 6 rights for small business owners along with the specific practices that lenders and brokers must abide by in order to uphold and protect those rights. It is important to note that these enhanced disclosure such as the SMART Box and The Small Business Borrowers' Bill of Rights are not intended to replace a lender's existing disclosures rather they are supplemental disclosures.

Lender	Loan Type	Amount	Term	Repayment	Other	Origination Fee	Personal Credit
OnDeck	Term Loan, LOC	\$5,000 - \$500,000	3-36 months	Daily or Weekly	\$20/mo	2.5% to 4%	500+
Lending Club	Term Loan	\$1,000 - \$300,000	12 - 60 Months	Monthly	Draw fee 1% to 2%	0.99 - 5.99%	fair personal credit
IOU Central	Term Loan	\$5,000 - \$300,000	6 or 18 month	Daily or Weekly	Small guaranty fee	8.80%	No specific minimum
Business Financial Services	Term Loan, MCA	\$5,000 to \$2M	3.5 - 36 Months	Daily or Weekly	Small fee	2% to 6%	above 475
CAN Capital	Term Loan, MCA	\$2,500 to \$150,000	4 to 24 months	Daily	Applicaton fees	3.00%	Better than average credit
Fundation	Term Loan	up to \$500,000	12 - 48 Months	Twice a month	Application fees	5.00%	Good credit
Fundation	Working Capital Loan	up to \$100,000	18 Months	Monthly	2% per draw	\$500	Good credit
Funding Circle	Term Loan	\$25,000 to \$500,000	12 - 60 Months	Weekly	Applicaton fee	.99% to 6.99%	Good credit
Merchant Capital Source	Term Loan,	\$5,000 - \$500,000	6 - 14 Months	Daily	Small fee	4% to 6%	575
Merchant Capital Source	Merchant Cash Advance	\$5,000 - \$300,000	5 - 12 Months	Daily	Draw fee 1.5% to 3%	Small fee	500

Note that several fintechs such as DealStruck and Raiseworks, which were founded around 2010-12 period have exited this market. Others such as CAN Capital have cut back on lending operations.

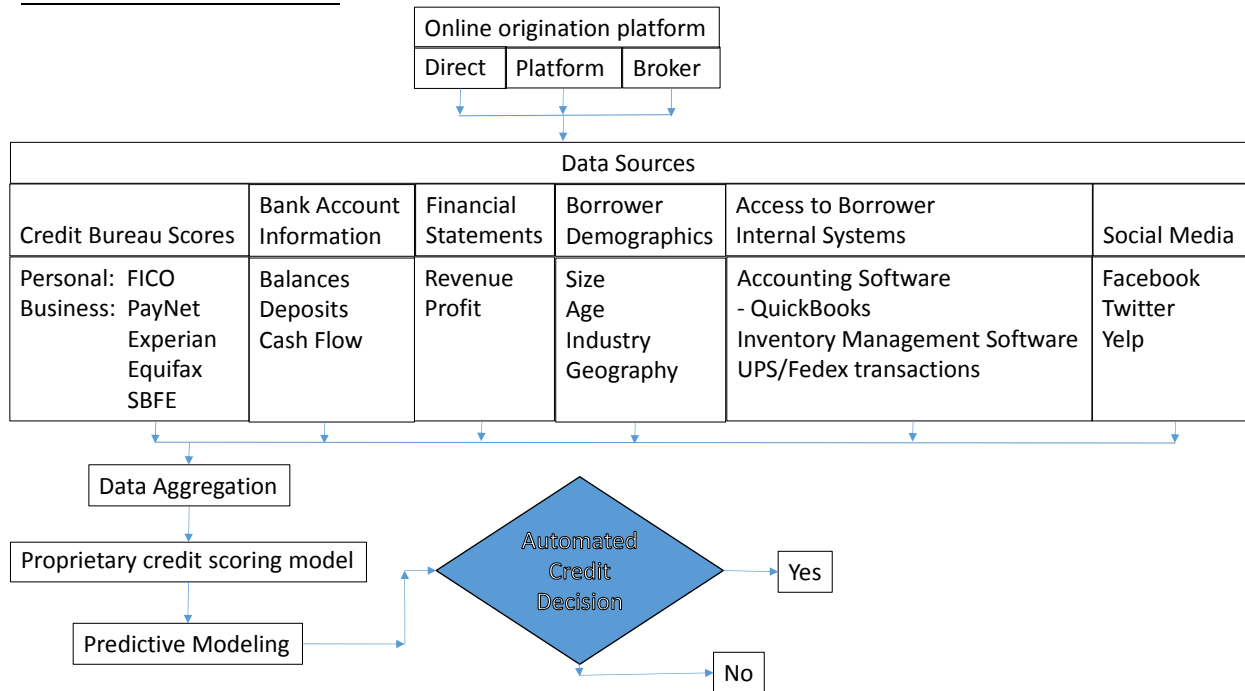
Credit Models and Process

While products are traditional, alternative lenders use non-traditional methods and data sources to grant credit. Data sources include credit bureaus, bank account statements, financial statements, tax returns, borrower demographics, borrower internal data and social media. The non-traditional metrics used by alternative lenders has partially obsoleted the traditional relationship-building process that used to take years to form between small businesses and community banks. Previously, a community banker would spend years forming a relationship with a local small business and understanding what the community thought of that small business. Now, alternative lenders can approximate that process in minutes by looking up the businesses' Yelp review, among other metrics that did not exist even a decade ago. This information is aggregated and run through proprietary credit models to arrive at a decision. This process runs on proprietary software developed by the lender to fit their business process. Many alternative lenders have invested considerable amounts of money to create the software and the credit models. The credit models use empirically derived and statistically sound model development methods to create a rank order of credit risk. Credit approval rates range from the mid 11% to 79% for lenders depending on the security and market segment.

Fintech lenders seek to control the financial data to ensure they are controlling access to their customer. Tech exists to deliver this now. Collection, data entry and spreading of financials are

a low value high cost step. Financial statement spreads are likely not done at the loan officer/senior credit officer level but they are required by bank policy and probably expected by the regulators. Banks often have a flood of renewals/restructures and annual reviews that requires prioritization.

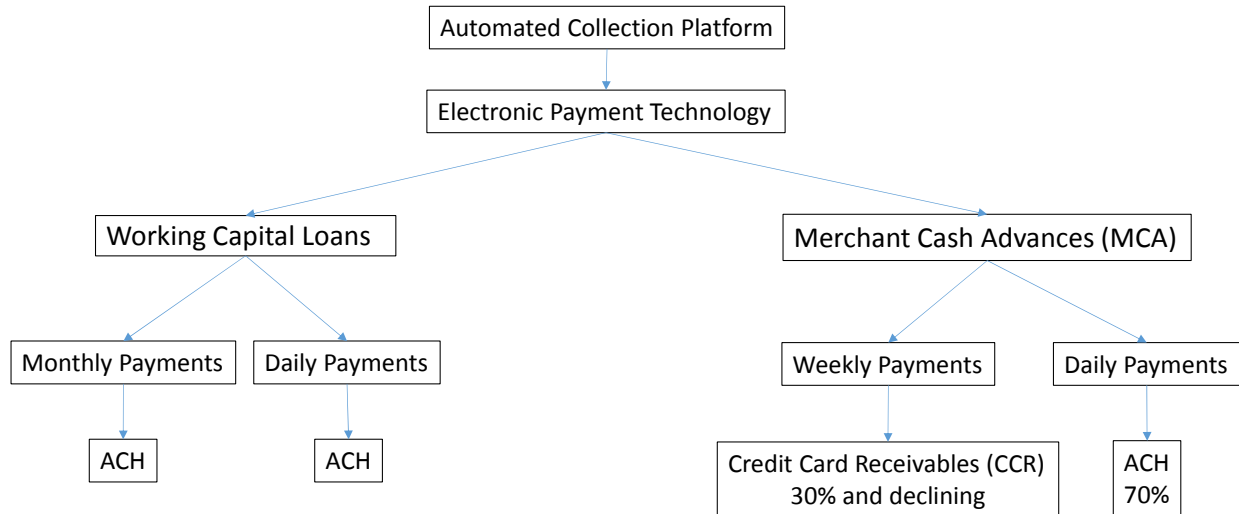
Automated Credit Process



One example of the unique use of data is the bank account information. Lenders link into the borrower’s bank account to track cash balance at will. This allows the lender to gain an early warning of inability to pay and to take more aggressive steps earlier. Lenders track credit on a daily basis. Another example of non-traditional data use is Google site visit. This is an online photo of the business. It enables the lender to see the business and gain an understanding of the location and property.

Another non-traditional aspect of marketplace lending is the daily repayment of the loan. In many cases the repayment is debited each day directly from the borrower’s checking account via ACH. Daily payment results in a different definition of default. For many lenders, 7 days or more past due becomes severely delinquent and default occurs after 60 days past due. In some cases payment schedules can vary from weekly to more traditional monthly term.

Loan Repayment

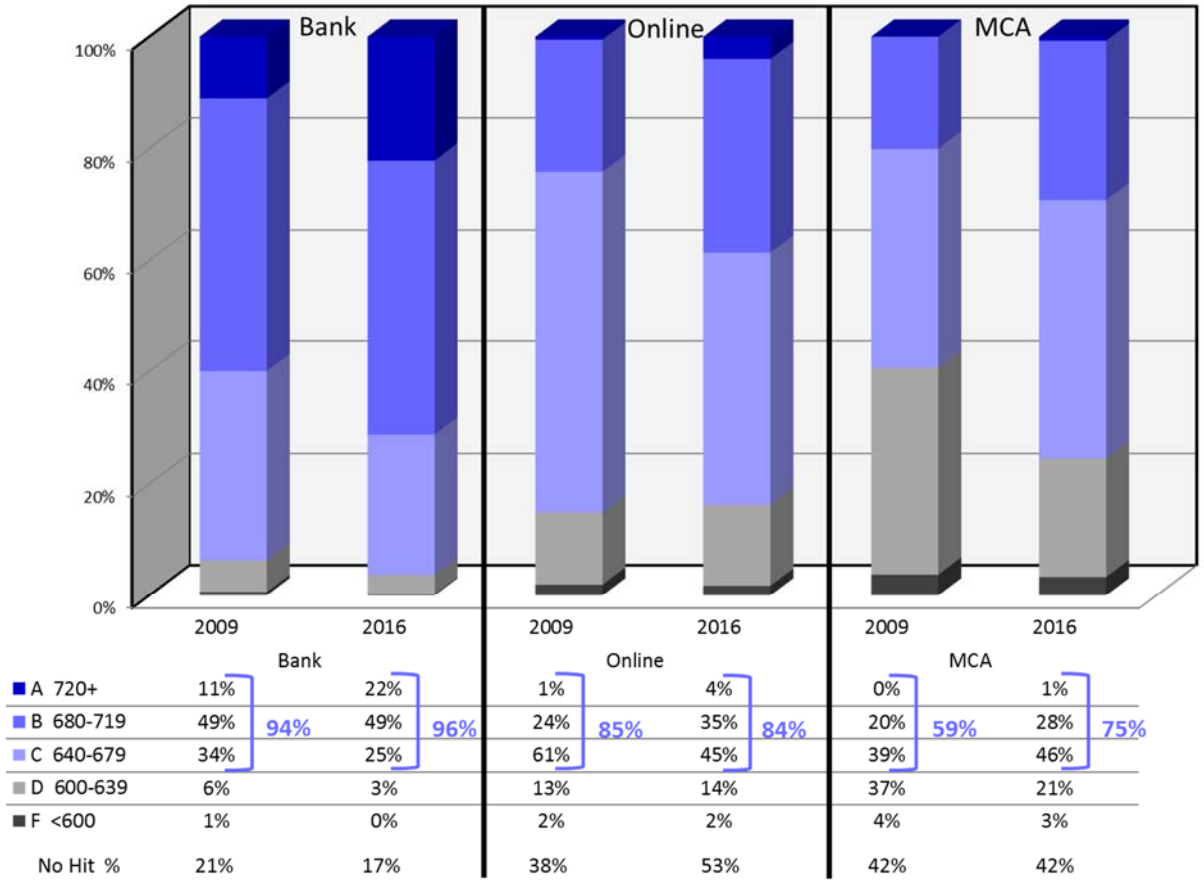


Fintechs have found ways to lower the cost of processing a credit application compared to banks. Some fintechs have lowered this operating cost to under \$500 per application versus banks which incur cost per application as noted above.

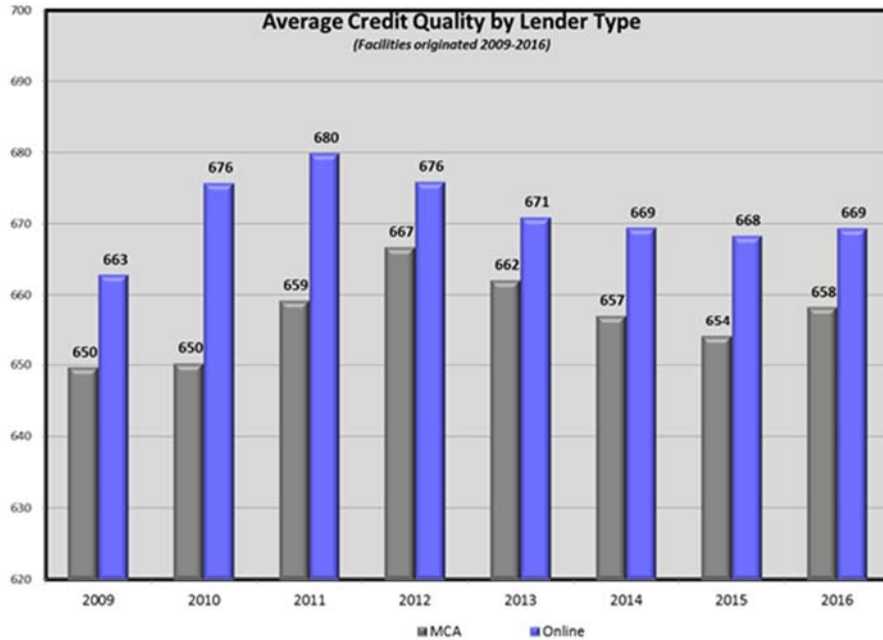
Borrower Credit Quality

PayNet analyzed the portfolios of marketplace lenders to determine the absolute level of credit risk and to determine differentiation by lender type. We found the following key insights into marketplace finance:

1. In 2016, 84% of Online lenders' portfolio quality stands at a score of 640 or higher. In comparison, 96% of banks' portfolio is the same credit quality.
2. Overall credit quality has improved for Online lenders from 663 in 2009 to 669 in 2016.
3. Credit migration shows that in 2009, 25% of Online lender's portfolio stood at 680 or higher; by 2016, the portion of these higher quality borrowers had increased to 38%.
4. Online/direct lenders show an average score of 669 in 2016, which equates to a default rate of approximately 10.5%. In contrast, new Bank originations had an average credit score over 700, which equates to a default rate of approximately 1.1%.
5. Average facility size for online lenders totals approximately \$65,000.
6. Average transaction term of an online loan is approximately 15 months in length. 34% of online loans are in excess of 18 months term which is a large increase from 0% in 2009.
7. 70% of borrowers that use online loans have been in business 10+ years. This compares to 77% for banks.

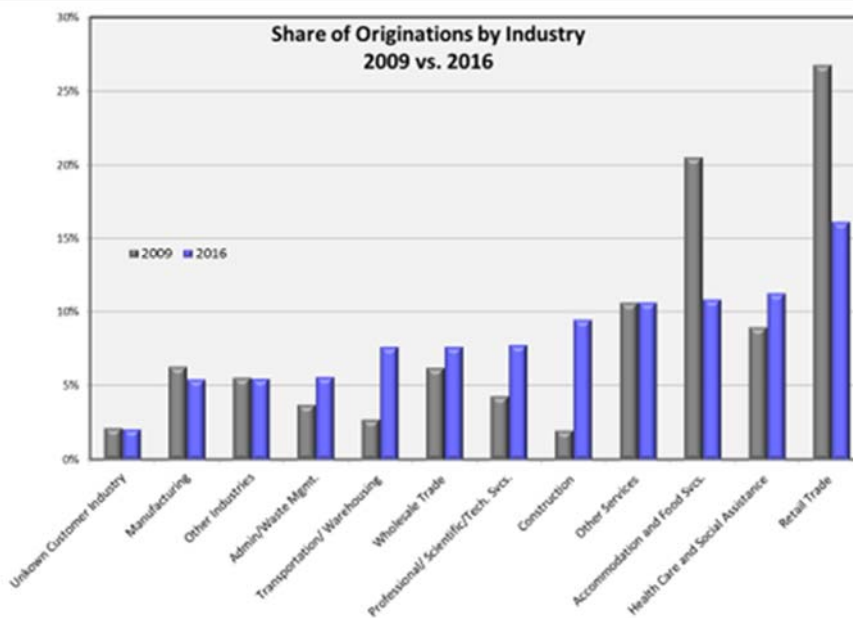


Marketplace lenders appear to overlap with a majority of banks' customers as measured by credit quality. B and C quality borrowers make up 74% of bank's customers and 80% of On-Line lender's customers. Note that calibration of credit models differs by lender type with the result that default rates can differ at the same credit score.



Online lenders are expanding their lending operations to provide credit to small businesses engaged in diverse industry sectors. As the chart Share of Originations by Borrower Industry shows, online loans are used by small businesses in retail, healthcare, accommodation & food, other, construction, professional services, wholesale, transportation, administration, and manufacturing industries.

Share of Originations by Borrower Industry 2009 vs. 2016



Impact of Online Lending on Small Businesses

Question: Does access to credit from online lenders result in improving credit quality for borrowers or do all borrowers deteriorate?

	Credit Quality	
	Start 1/1/2015	End 7/1/2017
Improved		66%
No Change	100%	10%
Deteriorated		24%

Findings:

- Of 100% of borrowers in 2015,
- 69% migrated to higher quality.
- 24% of borrowers migrated to a lower credit quality.
- 10% were unchanged.

Summary

Post financial crisis of 2009 clearly resulted in disruptions in the credit market for small businesses as traditional sources of credit like community, regional and large banks could no longer profitably supply credit or they were preoccupied with other more pressing issues in their businesses. Partly due to the JOBS Act and partly due to new applications of technology, innovators in the form of fintechs invented new ways to provide credit to small businesses to fill this “credit gap”. Fintechs have faced the challenge of building systems for sourcing borrowers, finding the capital to make loans and building the technology platforms to lower the cost of processing a credit application. Fintechs have excelled at building technology platforms to lower the cost of providing credit applications to small businesses. They still face high costs to find prospective borrowers and they face high costs of capital as a source for their loans. I note that since the dawn of fintech, several have decided to exit this market or they have gone out of business themselves.

It is clear that fintechs have not fully realized the potential they held several years ago when many equity analysts predicted fintech would transplant banks as a primary source of credit to consumers and small businesses. But fintechs have provided three critical benefits to the supply of credit to small businesses: first, they have figured out technology platforms to lower the cost of a credit application; second, they have changed the expectations among small businesses for access to credit working capital, which traditional sources cannot afford to offer at a reasonable cost; third, they are filling the

credit gap faced by small businesses across the credit spectrum and industry sectors. More work must be done by these innovators to improve their business models and I note that many fintechs are themselves small businesses.

Improvements in fintech business models include cheaper sources of capital that can be the source for lower priced loans. Another major improvement necessary for fintechs to become a long term source of credit for small businesses is to lower the cost to acquire their customers who are the prospective business borrowers. Also, many fintechs are addressing the capital and customer acquisition business issues through partnerships with banks. Most importantly, they must continue to work on their business methods to provide transparency, for example the ILPA provides with its SMART Box, on the terms of loan contracts with small businesses. Like any market of suppliers, lenders to small businesses provide varying degrees of information about their product to ensure their loan contracts are fit for the intended purpose. My concern is that fintech, in its early stage of development, could fail as an industry to fill the credit gap. This failure could result from lenders who do not fully inform borrowers on the terms of their loan contracts and in doing so, create the impression that all fintech lending is an untrustworthy source of credit. This could drive away other lenders that are providing better disclosure about the terms of their contracts and seeking to lower the cost of delivering credit to small businesses. In this scenario of market failure, less supply of credit becomes available for small businesses and the credit gap becomes a bigger issue.

APPENDIX: Methods and Sources

*Contract Count rounded to 10,000 increment

Assumptions Made

1. For commercial finance data, the Federal Reserve's [Finance Companies](#) estimate of the value of total loan and lease as a given, and then assume that the \$250k and below and \$1 million and below share of loans and leases balance outstanding contract count in the PayNet database—respectively—is representative of national data in each of the loan and lease segments for business lending.
2. For Alternative Lenders, we use the 2016 estimate of balance outstanding from the [Ernst and Young](#) report, and then assume that the \$250k and below and \$1 million and below balance outstanding contract count in the PayNet database—respectively—is representative of national data.
3. For Commercial Bank data, the assumption is that the data provided from the FDIC in the latest [Quarterly Banking Profile](#) is accurate.