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September 8, 2020

The Honorable Nydia M. Velázquez
Chairwoman
Committee on Small Business
United States House of Representatives
Washington, DC 20515

The Honorable Steve Chabot
Ranking Member
Committee on Small Business
United States House of Representatives
Washington, DC 20515

Chairwoman Velázquez, Ranking Member Chabot, Members of the Committee,

Thank you for the opportunity to submit a statement for the record of today's hearing on "Transparency in Small Business Lending."

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato's Center for Monetary and Financial Alternatives, of which I am an associate director, is dedicated to revealing the shortcomings of today's centralized, bureaucratic, and discretionary monetary and financial regulatory systems and to identifying, studying, and promoting alternatives more conducive to a stable, flourishing, and free society.

Recent Trends in U.S. Small Business Lending

U.S. small businesses account for 43.5 percent of U.S. gross domestic product and 47.3 percent of private-sector employment.[1] Yet they face unique challenges in their access to credit which the economic uncertainty stemming from the Covid-19 pandemic has underlined. Most small-business borrowers need relatively small loans that are individually expensive to underwrite, originate, and service unless done on a large scale.[2] But many small businesses also have special

[1] Kathryn Kobe and Richard Schwinn, "Small Business GDP 1998-2014," Small Business Administration Office of Advocacy, December 2018, p. 4; SBA, "2019 Small Business Profile," Office of Advocacy, 2019.
[2] Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Innovation and Technology and the Implications for Regulation," Harvard Business School Working Paper 17-042, 2016, p. 24-25.

circumstances and funding needs that do not fit the standard credit box, which explains why they have historically benefited greatly from relationship lending.[3]

Lenders of many different types cater to small businesses, from banks and credit unions to state-licensed finance companies offering both short- and longer-term loans. In recent years, a new category of lenders that use technology to simplify the borrowing process has emerged. Some of these new entrants have focused on making loan applications easier and more transparent, while others use their access to detailed business cash-flow information to improve underwriting. Still others prioritize quick access to funds, which is crucial to many small businesses that expect revenue tomorrow but need to pay bills today. As of 2019, 33 percent of U.S. small businesses seeking credit applied to online lenders.[4]

But not all recent trends are encouraging. Since the 2008 financial crisis, bank loans to businesses for amounts less than $1 million have grown at rates substantially below those of the pre-crisis period, and much more slowly than loans above that threshold. In the eight years to 2018, loans under $1 million grew only by 3 percent, compared with 80 percent for loans above that amount.[5] The extent to which nonbank lenders have helped to plug this shortfall is hard to estimate, but for years after the last recession small businesses reported tight credit conditions.[6] No sooner had the climate improved in late 2018 and 2019 than Covid-19 put the U.S. economy in recession, credit markets in disarray, and millions of small businesses in existential crisis.

But the public health emergency will pass. And policymakers can take steps that, in addition to easing small businesses' recovery, can permanently improve their access to capital. Here, I focus on three areas: the cost of credit, the use of data in underwriting, and the collection of small-business loan data for fair lending purposes. None of the policy approaches suggested need come at the expense of transparency; in fact, some of them would probably make credit terms and lender decision-making easier for small businesses to understand.

Cost of Credit: Caps, APR Disclosures, and Alternative Approaches

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[3] Mitchell A. Petersen and Raghuram G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *Journal of Finance* Vol. 49 No. 1 (March 1994): pp. 3-37; Allen N. Berger and Gregory F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *Journal of Business* Vol. 68 No. 3 (July 1995): pp. 351-381.

[4] Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis, and San Francisco, "Small Business Credit Survey: 2020 Report on Employer Firms," p. 15.

[5] Michael D. Bordo and John V. Duca, "The Impact of the Dodd-Frank Act on Small Business," NBER Working Paper 24501 (April 2018), National Bureau of Economic Research, p. 3.

[6] National Federation of Independent Businesses, "Expected Credit Conditions," accessed September 9, 2020. http://www.nfib-sbet.org/indicators/

According to the Federal Reserve Banks' Small Business Credit Survey, cost was the top reason small businesses cited for declining at least some of the credit for which they had been approved.[7] But the top three reasons for credit denial *by lenders*, according to the same sample of firms, were carrying too much debt, a low credit score, and insufficient collateral.[8] Firms in this situation can often only secure additional credit by offering to pay a higher interest rate. Because there is such a tradeoff between cost and other terms, blunt interventions like a statutory cap on loan interest are bound to backfire. And because women- and minority-owned firms tend to be smaller than other small businesses[9] and their owners tend to have lower credit scores,[10] they would bear a disproportionate share of a cap's impact on credit availability.

In an attempt to increase transparency, policymakers and some lenders have recently championed legislation mandating certain disclosures for small business credit, akin to those applicable to consumer credit.[11] Often, these initiatives have focused on a single cost measure, namely the annual percentage rate (APR), which proponents hope will make credit applicants better able to compare alternatives. But a single measure can deceive: The APR, for example, makes no distinction between products with different repayment schedules, even though avoiding upfront fees can clearly benefit liquidity-constrained small businesses. The APR also tends to favor loans with a longer term, even if they carry higher total charges than shorter-term alternatives.

The APR is a useful comparator for similar products, but it can mislead a borrower facing many options with different characteristics. A product's total dollar cost can often be a more accurate measure of affordability, especially for short-term credit. But making any single cost measure mandatory is risky, as it discourages lenders from competing on other product features that small businesses value, such as repayment flexibility and speed of access, because they become less visible. Instead of interest-rate caps and ineffective disclosure mandates, policymakers should seek to promote additional entry into small-business lending. They should also encourage innovation by lenders through programs such as the CFPB's trial disclosure sandbox.[12]

New Forms of Underwriting

While credit scores remain very important for credit decisions, many lenders have recently started to use additional data to underwrite applicants. Early evidence shows these additional

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[7] Federal Reserve Banks, "Small Business Credit Survey," p. 13.
[8] Ibid.
[9] Consumer Financial Protection Bureau, "Key Dimensions of the Small Business Credit Landscape," May 2017, p. 8 and 10.
[10] According to survey data, 88 percent of employer small businesses rely on the owner's personal credit score when they apply for credit. Federal Reserve Banks, "Small Business Credit Survey," p. 8.
[11] See, for example, S.B. 1235 in California, which became law in September 2018 and requires small business lenders to disclose credit terms, including cost as an annualized rate.
[12] 84 FR 48260, "Policy to Encourage Trial Disclosure Programs," September 13, 2019.

data can increase credit availability and reduce its cost for both consumers and small businesses.[13] But existing regulatory guidance, such as the Federal Reserve Board's 2011 letter on model risk management,[14] may discourage lenders from trying out innovative underwriting methods or doing business with firms that do, lest these methods be regarded as potentially discriminatory or unsound. And while the Supreme Court's 2015 *Inclusive Communities* ruling defined clear boundaries for disparate-impact claims, its application to future ECOA enforcement actions remains uncertain.

Even before the Covid-19 pandemic hit, many small businesses struggled to secure all the financing they sought. Although it is important for policymakers not to encourage the proliferation of credit that borrowers later cannot repay, they should also watch out against well-meaning supervisory and enforcement practices that drive out potentially beneficial innovation. As the Court noted in 2015, "liability must be limited so . . . regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant free-market economy."[15] If an innovation stands to make all or most borrowers better off, it should be welcome even if the benefits are unevenly distributed at the outset.

Loan Data Collection

Researchers benefit greatly from the public availability of loan data. For example, the finding cited earlier of a sluggish recovery in bank commercial lending to small businesses comes from FDIC Call Report data. But data collection also has costs, which can discourage lenders from participating in certain markets and serving certain customer segments. Even if a data collection requirement has net benefits, it can harm individual borrowers or groups by causing the withdrawal of marginal lenders for which the compliance cost is too high.

Congress and regulators should seek to minimize this unintended consequence in the small-business loan data collection mandated by Section 1071 of the Dodd-Frank Act.[16] While Section 1071 seeks to ensure fairness in lending to women- and minority-owned small businesses, its implementation could drive out thousands of small banks and credit unions with a relatively small commercial lending footprint. By exempting banks, thrifts, and credit unions with assets below $1 billion from Section 1071 requirements, Congress or the CFPB would relieve more

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[13] Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform," Working Paper 18-15 (January 2019), Federal Reserve Bank of Philadelphia; FinRegLab, "The Use of Cash-Flow Data in Underwriting Credit," Small Business Spotlight, September 2019.

[14] Patrick M. Parkinson, "SR 11-7: Guidance on Model Risk Management," Board of Governors of the Federal Reserve System Division of Banking, April 4, 2011.

[15] *Texas Department of Housing and Community Affairs, et al. v. Inclusive Communities Project, Inc., et al.* 576 U.S. 10 (2015).

[16] 15 U.S. Code § 1691c-2.

than 85 percent of these institutions from a heavy compliance burden, while still allowing for data collection on nearly 90 percent of their small-business loans.[17]

Conclusion: Promoting Transparency and Credit Availability

It is costlier for lenders to serve the smallest of small businesses and those in unusual circumstances. As a result, these businesses, owned disproportionately by women and minorities, often struggle the most to secure credit. But competition between a wide range of lenders and ongoing innovation and specialization have helped to bring costs down. While policy interventions can help to improve the transparency of loan terms and credit decisions, policymakers should be careful not to constrain the availability of credit in the process. Broad access to credit on competitive terms can make all the difference to small businesses fighting to survive the Covid-19-induced recession.

Thank you again for the opportunity to submit a statement for the record. I would be happy to answer any questions you may have at DZuluaga@cato.org.

Sincerely,

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[17] Diego Zuluaga, "Implementation Concerns of Section 1071 of the Dodd-Frank Act," Submission to the CFPB Symposium on Small-Business Lending, Cato Institute, November 6, 2019.