WOODSTOCK INSTITUTE

Advancing Economic Security and Community Prosperity

Board of Directors

Chair
Natalie Abatemarco
Citi Community Development

Vice Chair
Lori Vallelunga
Bethel New Life

Secretary
Michael Seng
The John Marshall Law School

Treasurer
Ghian Foreman
Greater Southwest Development Corporation

Members

Lehia Franklin Acox
LFA

Bobbi Ball
Partners in Community Building

James H. Carr
Housing Finance, Banking and Public Policy Consultant

Maria Choca Urban
Cook County Bureau of Administration

Byna Elliott
Fifth Third Bank

Adrian Esquivel
Enlace Chicago

Thomas FitzGibbon, Jr.
NHS of Chicago

Dunni T. Cosey Gay
Chicago Cook Workforce Partnership

Gordon Mayer
Gamaliel Foundation

George Lipsitz
University of California Santa Barbara

Dory Rand
Woodstock Institute

Ed Williams

Stacie Young
Community Investment Corporation

Founder
Sylvia R. Scheinfeld
1903-1990

September 30, 2015

Ms. Laura Temel
U. S. Department of the Treasury
1500 Pennsylvania Avenue
Room 1325
Washington, DC 20220

Re: Comment on the Treasury's Request for Information (RFI) on Expanding Access to Credit Through Online Marketplace Lending: Docket ID 80 FR 50071, pages 42866 – 42868, Docket Number Treas-DO-2015-0007

Dear Ms. Temel,

The following comments are submitted on behalf of Woodstock Institute (and Accion?). These comments primarily address one of three topic areas on which the Treasury Department is seeking comments: how the financial regulatory framework should evolve to support the **safe** growth of this industry. (Emphasis added.) The comments are organized on the basis of the *Key Questions* specified in the RFI.

General Comments

Overall, the current state of affairs in online lending has many similarities with consumer small dollar lending before some states adopted regulations to limit the most predatory and abusive practices. These comments, therefore, will use some examples from the consumer small dollar lending experience to illustrate problems and ways to address them, with the understanding that those loans are beyond the scope of this RFI. Policymakers and regulators need to remember always that small business owners are consumers in many respects. Just because people can create a product or service and market it does not mean that they are sophisticated financial managers competent to evaluate the relative merits of complex loan terms or develop data models to project the impact of automatic payment plans on cash flow over the life of loans with varying fees and rates.

On August 6, 2015, Responsible Business Lending Coalition members Accion, Aspen Institute, Fundera, Funding Circle, Lending Club, MultiFunding, Opportunity Fund, and Small Business Majority promulgated a Small Business Borrowers' Bill of Rights (BBOR). The BBOR contains six provisions that define the minimum standards to which online lenders should adhere and that all small business borrowers should have the right to expect from any lender, online or in-person:

1. The right to transparent pricing and terms, including a right to see an annualized interest rate and all fees;
2. The right to non-abusive products, so that the borrowers don't get trapped in a vicious cycle of expensive re-borrowing;
3. The right to responsible underwriting, so that borrowers are not placed in loans that they are unable to repay;

4. The right to fair treatment from brokers, so that borrowers are not steered to the most expensive loans;
5. The right to inclusive credit access, without discrimination; and
6. The right to fair debt collection practices, to prevent harassment and unfair treatment.

The BBOR provides a good starting point for a regulatory framework to support the safe growth of the online lending industry. The first component of the BBOR is one that should guide future policies, transparency – borrowers must have a clear understanding of the loan terms and costs, and they should be presented in a way that allows any borrower to easily compare different loan offers in order to be able to select the offer that best meets the borrower's needs. The BBOR transparency with respect to pricing and terms should be strengthened with a requirement for an all-inclusive Annual Percentage Rate (APR), as is disclosed for many other kinds of consumer credit. A recent study of online lending based on focus groups of small business owners found that "[v]irtually all of the focus group participants said they want clearly stated product features and costs and an easier way to compare product offerings. Among their suggestions were interest rates expressed as APRs, straightforward explanation of all fees, and required statements about payment policies, including late fees and prepayment penalties."[1]

Question 1: There are many different models for online marketplace lending including platform lenders (also referred to as "peer-to-peer"), balance sheet lenders, and bank-affiliated lenders. In what ways should policymakers be thinking about market segmentation; and in what ways do different models raise different policy or regulatory concerns?

One of the most important provisions of the BBOR is that the lender make loans only when it has high confidence that the borrower will be able to repay the loan on its original terms without defaulting or additional borrowing. As we have seen so frequently in the consumer small dollar lending field, too many lenders have a business model that relies on borrowers' inability to repay and the need for roll-over loans or repeat borrowing for profitability. The ability to repay provisions in the BBOR are meant to ensure that small business borrowers do not fall into the same predatory traps that payday, cash advance, and auto title lenders have inflicted on consumers.

The concern about lenders with a predatory, debt-trap business model is most pronounced for platform lenders that do not retain the credit risk of the loans and with lenders who receive repayment directly from gross sales. Both business models allow lenders to profit on loans with almost no regard to the impact of the loan on the viability of the business. Lenders who sell the loans to investors profit immediately, as originators of predatory mortgage loans did when they securitized and sold the loans to investors. Merchant cash advance lenders take their profits from the short-term cash flow of the business, which may bleed essential working capital that the business needs to survive, just as payday lenders take their payment out of the borrowers' bank accounts, frequently leaving them with too little left in the account to pay other bills, such as rent. Requiring a lender to retain credit risk is necessary to ensure that the lender's interests are aligned with the borrower's interest, with both benefitting from the long-term viability of the each borrower's business.

An additional concern with merchant cash advance lenders arises when they require direct access to borrowers' bank accounts to ensure repayment of loans. In small dollar consumer lending, not only have such arrangements prevented borrowers from managing their cash flow and debt payments, in many cases leaving borrowers with insufficient funds to pay other obligations, borrowers have found that their banks will not honor their orders to stop the automatic withdrawals without the consent of the lender. In effect,

---

[1] Lipman, Barbara J., and Ann Marie Wiersch, 2015. *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups*, A Special Report of the Federal Reserve Bank of Cleveland, p. 3.

the lender has more control over the account than the borrower and has priority over all other creditors seeking payment. We believe lenders should not have direct access to a borrower's bank account, regardless of whether it is a small business loan or a consumer loan. At a minimum, the Electronic Funds Transfer Act must be strengthened to prohibit direct access to a borrower's bank account and ensure that ACH authority can be revoked at any time.

Policymakers and regulators must ensure that the abuses that trap consumers in a cycle of debt and that are so prevalent in consumer lending do not spill over into small business lending. Policymakers and regulators must be especially vigilant with respect to business models that do not include lenders retaining a significant level of the credit risk, and a true "ability to repay" assessment should be required for all business and consumer loans, regardless of the organizational or business model of the lender.

Another issue that relates to the model is with respect to bank-affiliated lenders. Apparently, some lenders are using bank affiliation as a way to have federal standards preempt more stringent state regulations and licensing requirements. This has clearly been an issue with consumer lenders that have used bank affiliation and other techniques to avoid state usury laws or, for example, to make auto title loans to residents of states where such loans are prohibited. Policymakers and regulators should ensure that online lenders are not able to evade the consumer and business borrower protections in state law by affiliating with a bank in a more loosely regulated state and claiming the benefits of federal preemption.

Question 6 (part): How does the assessment of small business borrowers differ from consumer borrowers? Does the borrower's stated use of the proceeds affect underwriting for the loan?

Whether the assessment of small business borrowers should differ from consumer borrowers depends, in large part, on the purpose of the loan. Businesses borrow money for relatively short periods of time for a variety of different reasons, from purchasing inventory, raw materials, or equipment to managing short-term cash flow deficiencies. Consumers most frequently use short-term small dollar loans to cover cash flow deficiencies or to meet emergency expenses that cannot be covered by savings. Loans to purchase inventory, material, or equipment may result in the business increasing its income as those purchases are brought into the operation of the business. Regardless of whether the borrower is a business or consumer, however, borrowing to cover cash-flow deficiencies does not increase income.

The purpose of the loan, therefore, is important in determining the appropriate measure for the borrower's ability to repay the loan. Businesses that are borrowing to cover short-term cash flow needs are acting like consumers of small dollar loans, and the appropriate ability to repay standard should be based on current income and expenses. That standard, however, is not necessarily appropriate for business owners seeking funding for additional inventory, raw materials, or other purposes directly related to expanding operations and increasing income. In that case, lenders should be able to consider reasonable projections of increased income as part of borrowers' ability to repay any loan.

The difficulty is in the characterization of the loan purpose in situations in which the purpose is not entirely clear. A loan to purchase raw materials that can be processed and sold at a profit to generate income might increase income enough to repay the loan, but the need for the loan may also indicate that the business is not generating adequate income to fund replacement of the materials. The distinction is whether the loan will allow the business to expand or simply maintain the existing level of activity.

To the extent that the regulatory framework is to support the safe growth of the online lending industry, the lessons from consumer small dollar loans and the explosive growth of the subprime and predatory mortgage lending industry should inform policymakers and regulators. Trapping borrowers in a cycle of debt and repeat borrowing are an integral part of some business models, as are loans with terms that virtually guarantee that the borrowing is unsustainable. Ensuring that borrowers have the ability to repay

is crucial, and the presumption should be that the appropriate standard is based on the business' current income absent clear and convincing evidence, as required by strict underwriting standards, that the loan will allow the business to expand and increase income enough to repay the loan.

Question 7 (part): What issues are raised with online lending across state lines?

The issues with respect to online business lending across state lines are similar in many respects to consumer lending across state lines, that is, the ease with which lenders are able to avoid state protections and limitations on predatory loan products. Using a variety of legal structures and techniques, online lenders routinely make loans that exceed state usury caps and auto title loans to residents of states where such loans are prohibited by state law.

While a uniform, national standard may be in the industry's best interest in avoiding the complexity of having to accommodate the demands of 50 different state standards, current federal preemption seems to favor the lowest common regulatory denominator, the state with the lowest level of consumer protection. That state of affairs is completely incompatible with any regulatory framework that supports the safe growth of the online lending industry, unless the definition of safety refers only to the perspective of the industry, without regard for the safety of consumer or business borrowers. The definition of safe growth must include safety from the perspective of the borrowers in any regulatory framework.

Question 10 (part): Under the different models of marketplace lending, to what extent, if any, should platform or "peer-to-peer" lenders be required to have "skin in the game" for the loans they originate or underwrite in order to align interests with investors who have acquired debt of the marketplace lenders through the platforms?

As noted in the response to Question 1, marketplace lenders profit from the fact of making the loan and selling it, without regard to the performance of the loan or business borrower. In that respect, they are similar to the predatory mortgage lenders who securitized and sold their loans in the secondary market. Those lenders were able to continue making unsustainable loans because their business model did not depend on sustainability over time. They retained none of the risk of nonperformance, shifting that risk to borrowers and investors.

Risk retention requirements can help align the interests of lenders with those of borrowers and investors, and it need to be part of any regulatory framework for the online lending industry. Risk retention, however, is not the only alternative that policymakers and regulators should consider because of the additional capital requirements it would impose on a segment of the online business lending industry that, in its current form, can operate with relatively little of its own capital. For example, certain types of investments can be sold only to "accredited investors" who meet defined criteria, and the concept might be applied to limit sales of loans in which the lender did not retain risk to investors who meet similar criteria to ensure that they are financially sophisticated and can bear the loss in the event that the borrower defaults. Another option might be to define underwriting standards for the online lending equivalent of a "qualified residential mortgage" that would allow the lender to avoid having to retain some of the risk. The standards for loans that would not require risk retention would have to be carefully crafted to ensure that only soundly underwritten loans with the highest standard of ability to repay assessment are exempt.

Question 11: Marketplace lending potentially offers significant benefits and value to borrowers, but what harms might online marketplace lending also present to consumers and small businesses? What privacy considerations, cybersecurity threats, consumer protection concerns, and other related risks might arise out of online marketplace lending? Do existing statutory and regulatory regimes adequately address these issues in the context of online marketplace lending?

Marketplace online lenders pose all of the same threats to borrowers that unregulated small dollar consumer lenders do. Those threats include the full array of documented problems in the small dollar lending field, such as predatory loan products that can drain equity and lead to bankruptcy, unclear and abusive loan terms trapping borrowers in a cycle of debt, hidden and unclear fees, steering borrowers into unnecessarily costly loans, and abusive collection practices, among other risks. Because marketplace lenders are so lightly regulated, because federal law makes it easy to evade state-level protections and regulations that might prevent some of the worst abuses, and because of the lack of transparency and comparability of terms, marketplace lenders can potentially create any kind of harm lenders could possibly inflict in the absence of meaningful regulatory limits.

As noted earlier, small business owners are not necessarily financially sophisticated. Even if they are financially literate, they almost certainly know less about their borrowing options than online marketplace lenders whose business it is to know what the alternatives are. Just as some mortgage brokers steered applicants into high-cost loans when they qualified for better terms, online marketplace lenders can easily steer applicants into more expensive loans than necessary due to the asymmetry of information. A similar problem exists with respect to retirement savings investment advice, when financial advisors recommend investment options based on maximizing their own income rather than what is the most suitable investment for the client. To address the problem with respect to retirement accounts, the Department of Labor has proposed a rule that would make more advisors subject to fiduciary standards under the Employee Retirement Income Security Act, requiring them to act in their clients' interest. A similar standard should apply to at least some online marketplace loans, especially those most likely to go to businesses that do not have independent financial management and advice. A clear definition of the limits of the fiduciary duty will have to consider the size of the business and the loan.

Regulators also need to monitor the use of third-party brokers and lead generators who match borrowers with potential lenders. While the use of brokers may not yet be common in online small business lending, lead generators are already commonplace in online consumer lending. Lead generators collect personal information, such as bank account and social security numbers, directly from borrowers and then sell the information to lenders. When a person searches for consumer loan options, such as a payday loan or auto title loan, the initial search results are usually lead generation websites, not direct lenders. In fact, the majority of online applicants actually input their information into a lead generation website according to a 2014 study by Pew.[2]

The problem with brokers and lead generators is that their compensation is not necessarily based on securing the best loan from the borrower's perspective. Just as mortgage loan officer compensation formulas may have led some loan officers to steer borrowers into higher cost loans than they should have received to boost the loan officer's income, brokers and lead generators may have incentives to steer online borrowers into more expensive loans, such as higher fees paid for referrals by some lenders. At the very least, regulators need to monitor what sort of marketing or affiliate incentives online lenders offer to ensure that lead generation does not steer borrowers to higher cost loans than necessary. Alternatively, a fiduciary standard, such as the one applicable to retirement investment advisors could be appropriate to ensure that the broker or lead generator is acting in the borrower's interest.

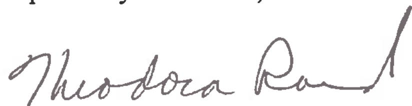
We also encourage regulators to monitor any alternative underwriting formulas that lenders might use. While the use of new technologies and the availability of alternative data beyond a consumer's traditional credit score has the potential to expand access to credit, they must be carefully monitored. Assessing a person's bill payment history is very different than monitoring publicly availably county or state records, or accessing an individual's social media platforms. We encourage regulators to work with lenders to

[2] *http://www.pewtrusts.org/~/media/assets/2014/10/payday-lending-report/fraud_and_abuse_online_harmful_practices_in_internet_payday_lending.pdf*

better understand the variables and factors that each entity uses in its underwriting process and to ensure that they do not have a disparate impact on different classes of potential borrowers.

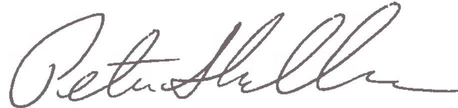
The BBOR is a voluntary statement of principles to which ethical lenders small business lenders may adhere, and the fact that some in the industry felt such a document was necessary shows the extent to which current statutory and regulatory regimes fall short. The lenders that promulgated the BBOR are to be commended for taking a first step and articulating principles that should guide the industry. Experience has shown, repeatedly and unfortunately, that such efforts at industry self-regulation do not suffice. Policymakers and regulators need to act before the potential for abuse and exploitation becomes reality at levels that have a seriously negative impact on small businesses and communities.

Respectfully submitted,

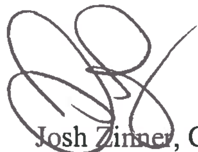


Theodora Rand, President
Woodstock Institute

Paulina Gonzalez, Executive Director
California Reinvestment Coalition



Peter Skillern, Executive Director
Reinvestment Partners



Josh Zinner, Co-Director
New Economy Project

OFFICE OF THE CITY TREASURER

KURT A. SUMMERS, JR. · TREASURER · CITY OF CHICAGO

September 30, 2015

Laura Temel
U. S. Department of the Treasury
1500 Pennsylvania Avenue
Room 1325
Washington, DC 20220

Re: Comment on the Treasury's Request for Information (RFI) on Expanding Access to Credit through Online Marketplace Lending: Docket ID 80 FR 50071, pages 42866 – 42868

Dear Ms. Temel,

This letter is to express our agreement with and support for the comments that Woodstock Institute has submitted in response to the Request for Information (RFI) on Expanding Access to Credit through Online Marketplace Lending.

Sincerely,

Kurt Summers
Treasurer
City of Chicago

121 NORTH LASALLE STREET, ROOM 106 • CHICAGO, IL 60602 • TELEPHONE: 312.744.3356

Accion Chicago
1436 W. Randolph Street, Suite 300
Chicago, IL 60607

September 30, 2015

Laura Temel
U. S. Department of the Treasury
1500 Pennsylvania Avenue
Room 1325
Washington, DC 20220

Re: Comment on the Treasury's Request for Information (RFI) on Expanding Access to Credit through Online Marketplace Lending: Docket ID 80 FR 50071, pages 42866 – 42868

Dear Ms. Temel,

This letter is to express our support for the comments that Woodstock Institute has submitted in response to the Request for Information (RFI) on Expanding Access to Credit through Online Marketplace Lending.

As a member of the BBOR we feel strongly that Treasury and other appropriate government regulatory agencies need to pay close attention to all aspects of this growing market which is impacting, often in a negative way, small business owners from growing into successful and sustainable business in their community.

Sincerely,

Jonathan Brereton
CEO

Tel 312.275.3000 Fax 312.275.3010 www.accionchicago.org