Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending

Written Testimony of

Gerron S. Levi

Director of Policy & Government Affairs

National Community Reinvestment Coalition (NCRC)

Before the Subcommittee on Financial Institutions & Consumer Credit

House Committee on Financial Services

U.S, House of Representatives

July 12, 2016

Introduction

Good afternoon, Chairman Neugebauer, Ranking Member Clay and other distinguished members of the House Subcommittee on Financial Institutions and Consumer Credit. My name is Gerron Levi, and I'm the Director of Policy and Government Affairs for the National Community Reinvestment Coalition. NCRC and its over 600 grassroots member organizations create opportunities for people to build wealth. We work with community leaders, policymakers and financial institutions to champion fairness in banking, housing and business development. I appreciate the opportunity to testify this afternoon about developments in the FinTech market, the current regulatory structure and recent policy development.

Much of my testimony today will focus on non-bank lenders who make small business loans, with occasional reference to small dollar lending and other FinTech activities; I draw significantly from NCRC's comments to the Office of the Comptroller of Currency ("OCC") on their recent request for information on innovation, and I'd like to acknowledge my colleague Josh Silver's contributions on that score.

The rapid growth of non-bank lenders – so called "Marketplace" lenders – to small businesses raises serious concerns that Congress should address. We see echoes of the early days of the subprime mortgage boom, in which rapidly growing non-bank mortgage lenders innovated in the worst possible way: by loosening credit standards, layering significant and multiple forms of risk, and causing financial harm to borrowers who could ill afford to repay the loans. If lightly regulated non-bank small business lenders – including FinTech firms – are left unchecked, our fear is the impact may be the same: millions of small businesses stuck with exploding loans they can't afford, and the American taxpayer left on the hook to clean up the mess.

For example, one of our members, PathStone Enterprise Corporation based in Rochester, New York, reports:

> **"**We have started to see small businesses saddled with high interest rate loans from marketplace lenders, unaware of the more problematic aspects of the loan. For example, they don't know that they have also agreed to significant prepayment penalties that make it impractical to refinance the loan. They are also unaware that the interest compounds daily and that there are daily payments pulled directly from their bank account. The flow of small business borrowers starting to come to us with problem loans is reminiscent of the early days of counseling borrowers stuck with a bad mortgage."

While the scale is currently different from non-bank mortgage lending, both the regulatory infrastructure and the incentive structure within which most FinTech firms operate may contribute to risky small business or consumer lending that is of serious concern to NCRC and its members.

Will innovation balance access to credit, convenience and needs, and borrower protection?

When evaluating these online lending platforms and their sophisticated underwriting algorithms, NCRC is certainly interested in expanding safe and sustainable credit access, but also in the process these channels raise other concerns that could undermine the sustainability of the marketplace lending model, lead to regulatory arbitrage, and mask predatory practices and fair lending violations in the marketplace.

FinTech innovation has distinct connotations depending on whether the stakeholder is a banker, regulatory agency, small business, or community organization. Financial institutions often consider innovations as concepts or processes that save money and increase profits.

From a community perspective, innovation should mean developing the means to serve underserved communities on a large scale in a responsible and sustainable manner. For example, the thirty-year mortgage was a key innovation that dramatically increased homeownership among working class and middle class families for decades. In contrast, other supposed "innovations" such as subprime lending and private label securitization wiped out a significant amount of the gains in homeownership and equity building in minority and low- and moderate-income communities.

Whatever innovation FinTech firms bring to the marketplace, Congress and the regulators should act to ensure it is responsible, and that consumers actually benefit from the innovation.

The romance and reality of FinTech: will it develop the large-scale ability to responsibly serve consumers?

There is no doubt that innovative solutions are needed to address a fundamental issue: small business lending is down, and businesses are dying on the vine for lack of credit. For example, the number of loans issued by 10 of the largest banks in the U.S. has decreased 38 percent to $44.7 billion in 2014, the Wall Street Journal reports, down from a peak of $72.5 billion in 2006.[1]

Enter financial technology firms offering enticing, easy to use platforms that deliver loans within hours and days, not weeks. With a click of a button, a consumer can get a loan. But can online platforms serve borrowers efficiently while balancing consumer protection concerns, or is lending an inherently complicated business that requires care, deliberation, and a high-touch process?

A recent Treasury Department paper examining online lending indicates that a key feature is loan approval within 48 to 72 hours.[2] The allure of the ease has helped fuel a boom in the so-called "FinTech" industry. In its white paper, the OCC estimates that FinTech companies in the United States and the United Kingdom increased to more than 4,000 and that investment in FinTech companies has surpassed $24 billion worldwide.[3] FinTech companies tout up-and coming-technology that appears particularly well suited to the Internet and digital proclivities of the millennial generation now starting to enter their prime earning years and pursuit of homeownership.

[1]Simon, Ruth, "Big Banks Cut Back on Loans to Small Business" *Wall Street Journal*, November 26, 2015: http://www.wsj.com/articles/big-banks-cut-back-on-small-business-1448586637

[2] U.S. Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, p.5.

[3] Office of the Comptroller of Currency, *Supporting Responsible Innovation*, p. 3, March 2016.

Market analysts estimate marketplace lenders' loan origination volumes could reach $90.0 billion by 2020.[4] The current volume, however, still pales in comparison to an estimated $1 trillion addressable market, or the current small business holdings of $598 billion by banks.[5]

Ominous signs, however, counsel caution regarding the promise of FinTech to sustainably and responsibly serve small businesses.

For example, a recent survey of small businesses by several Federal Reserve Banks reveals that 20 percent of small businesses obtaining credit used online lenders and that microbusinesses used online lenders to a greater extent. However, online lenders received low satisfaction scores. Only 15 percent of small businesses using online lenders were satisfied. Small businesses complained about lack of transparency and unfavorable repayment terms. Seventy percent of those unsatisfied complained about high interest rates.[6] A recent study of marketplace loans by NCRC member the Woodstock Institute found effective interest rates (including fees) ranging from 36-367% across a variety of providers.

Additionally, the ability of FinTech firms to comply with a range of consumer lending protections, as well as operate safely and soundly, has been brought into sharp relief by the recent Lending Club scandal, in which the firm's CEO resigned following the discovery that the firm had essentially committed fraud through the misrepresentation of loans.[7] Some reports have suggested that such a significant lack of internal controls are not limited to Lending Club, but might be endemic to the industry, rendering them unable to survive a normal business cycle.[8] In fact, charge-off rates have recently risen dramatically at Lending Club, up 38% since 2013, raising the possibility of further defaults and financial woes.[9]

Additionally, the ability of FinTech firms to attract sustainable sources of capital is another area of concern. Investments are slowing down in FinTech.[10] In the wake of the Lending Club scandal, investors are increasingly concerned about the online and FinTech model and how well it can withstand recessions as well as healthier economic times. NCRC is concerned that FinTech

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[4] United States Department of Treasury, *Opportunities and Challenges in Online Marketplace Lending*, p.9, May 10, 2016:https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf

[5] Guta, Michael. "Big Banks Still Lend Small Businesses Less Than a Decade Ago." *Small Business Trends*. Small Business Trends, 06 Dec. 2015.

[6] Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis, *2015 Small Business Credit Survey, Report on Employer Firms*, see https://www.frbatlanta.org/research/small-business/survey/2015/report-on-employer-firms.aspx?panel=2

[7] Rudegeair, Peter, "Lending Club CEO Fired Over Faulty Loans," *Wall Street Journal*, May 9, 2016:http://www.wsj.com/articles/lendingclub-ceo-resigns-over-sales-review-1462795070

[8] Corkery, Michael, "As Lending Club Stumbles Its Entire Industry Faces Skepticism", *New York Times*, May 9, 2016: http://www.nytimes.com/2016/05/10/business/dealbook/as-lending-club-stumbles-its-entire-industry-faces-skepticism.html?_r=2

[9] Demos, Telis and Rudegeair, Peter, "Lending Club's Newest Problem: Its Borrowers, *Wall Street Journal,* July 11, 2016: http://www.wsj.com/articles/lendingclubs-newest-problem-its-borrowers-1468265212

[10] Demos, Telis and Rudegeair, Peter, "Has Fintech Boom Peaked?", *Wall Street Journal,* January 20, 2016: http://www.wsj.com/articles/has-fintech-boom-peaked-1453458781

firms could find deposits an attractive source of capital, and begin to blur the line between different lines of business, such payment systems, lending, and deposit taking.

Borrowing significant sums of money is a complex financial transaction. For many consumers, particularly low- and moderate-income consumers, it is the most complicated transaction they will ever undertake. Executed responsibly, lending can empower consumers and enable them to build significant equity. Executed irresponsibly, lending can result in financial ruination. And given its complexity, lending often requires significant amounts of counseling and underwriting to ensure that borrowers can afford the loan and make payments. A click of a mouse and fancy algorithms are often no substitute for patient counseling and careful underwriting, particularly for those unfamiliar with lending and not possessing an established credit history.

Data and transparency concerns

In order to realize a consumer- and community-friendly definition of innovation, regulatory agencies must develop systems for monitoring performance of financial institutions. The development of data systems is one of the most important ways to effectively measure whether financial institutions are achieving innovation as defined by serving minority and working class communities at a large scale with responsible products. The Home Mortgage Disclosure Act (HMDA) data is valuable in measuring the volume and percent of loans to minorities and low- and moderate-income borrowers. But HMDA data needs to be supplemented with data on loan performance including delinquency and defaults to determine not only whether institutions are reaching the underserved but also whether their products are sustainable and safe and sound. Also, the new Dodd-Frank[11] HMDA data elements regarding loan terms and conditions will provide additional insights into the sustainability and affordability of loans.

When HMDA data is more effectively paired with data on loan performance and loan terms and conditions, regulators and the general public can compare institutions regarding the extent to which they are responsibly reaching underserved populations. These analyses would involve comparing institutions with traditional technology and those with “innovative” technology such as online lending platforms to actually determine which institutions are more effectively serving overlooked populations. It is NCRC’s position that if traditional institutions reach a higher percentage of minority and modest income borrowers with safe and sound loans than institutions with newer technology, then the traditional institutions are actually more innovative from a consumer and community perspective.

Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires lending institutions to publicly disseminate data on their small business lending activities. The purpose of the section is, "to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses." This critical purpose of ensuring that lenders are held accountable for responsible lending to traditionally underserved businesses will best be fulfilled if the data reporting requirement is applied broadly throughout the financial industry to include not only banks but also non-bank financial institutions such

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

as FinTechs. The Consumer Financial Protection Bureau (CFPB) will be undertaking a rulemaking process in the near future. Interested stakeholders and members of Congress should convey to the Board the necessity of broad coverage of the financial industry, which is authorized under Section 1071 of Dodd-Frank.

Fair lending concerns

A significant market advantage of many Fintech firms, is their use of Big Data to underwrite loans. Advocates for Big Data argue that it improves credit risk profiling, and may expand the number of people "scored," expanding access to credit. But does Big Data truly represent an improvement, or is it simply skating around the guardrails in place for good reason?

Vigorous enforcement of the fair lending laws is vital since FinTech companies apply opaque algorithms to assess borrower applications. The Treasury Department, in its paper, notes concerns regarding the possibility of fair lending violations due to the use of new data and credit models using undisclosed methodology. The Treasury Department adds that unlike the traditional credit report model, consumers will not have the ability to check and verify the personal data used by FinTech companies to determine loan eligibility.[12] The agencies must collaborate in vetting the credit review and approval methods of FinTech companies to guard against discrimination and fair lending violations.

Enforcement authority may need to be shifted in order to respond effectively to technological change. For example, enforcement of the Equal Credit Opportunity Act (ECOA) is currently split among the prudential bank regulatory agencies and the CFPB. The bank agencies enforce ECOA when banks have assets of less than $10 billion while the CFPB enforces ECOA when banks have assets of $10 billion or more. The CFPB enforces ECOA in the case of non-depository mortgage companies. Splitting authority among several agencies for enforcing a fair lending law risks inconsistencies in enforcement. Since the CFPB is currently in charge of enforcing ECOA in the case of the large banks and non-depository mortgage companies, it would make the most sense if the CFPB was in charge of all ECOA enforcement including for smaller banks and any FinTech companies receiving a bank charger. At the very least, Dodd-Frank requires cooperation in fair lending enforcement among the prudential bank regulators and the CFPB. In the case of smaller banks (including any FinTech companies), Dodd-Frank mandates that the federal bank agencies grant the CFPB examiners the opportunity to participate in the exam, review exam documents, and offer input. It would seem that these procedures are especially needed when examining small banks with new FinTech-like technologies that may eventually be adopted by larger banks and mortgage companies under the jurisdiction of the CFPB.[13]

The legal and regulatory response to FinTech

[12] U.S. Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, p. 20.
[13] Congressional Research Service, The Consumer Financial Protection Bureau, A Legal Analysis, January 2014, https://www.fas.org/sgp/crs/misc/R42572.pdf

The regulatory response to FinTech companies will be critical in determining whether they are helpful and responsible financial institutions or whether they will become another in a line of predatory lenders that will ultimately become extinct after fleecing borrowers. The objective must be to apply a comprehensive set of regulations to FinTech companies and more traditional lenders so that consumers and financial institutions can both thrive in the marketplace.

The OCC has already put out feelers to the industry and dangled some regulatory favors in front of them. An American Banker article features a senior OCC regulatory official discussing a limited purpose charter for FinTech companies so that they can become nationally chartered banks and avoid the hassle of seeking licenses in multiple states.[14] But before the OCC offers a limited purpose charter to any new financial institution and confers the enormous benefits of a national charter, it must ensure that the institution is responsible (Also NCRC opposes a national charter that would allow a FinTech to operate as a non-bank; it would need to convert to a bank).

Importantly, while the OCC has asked for comments about innovation, several agencies including the OCC have also requested comment regarding reforms to the consumer compliance rating system. In its comments on the rating system, NCRC advocated for public input to examiners conducting compliance reviews and for the public release of ratings. The ratings could then be key for considering applications by non-banks including FinTech companies for bank charters. Only FinTech companies and other non-bank entities with the highest proposed rating (a proposed "1") should be allowed to acquire a national charter from the OCC.[15] In order to be eligible for a bank charter, a non-bank entity must have an outstanding record (a "1" rating) of compliance with consumer and fair lending compliance law.

The limited purpose charter as currently applied in the Community Reinvestment Act (CRA) examination context amounts to an easy-pass with no accountability for so-called limited purpose banks that make substantial amounts of retail loans. Under the current CRA regime, any FinTech "bank" designated as limited purpose would have a CRA exam that fails to scrutinize its retail lending. Would it be acceptable, for example, if a company named "Lending Club" that has issued $18 billion (and $2.7 billion last quarter) of loans to consumers and small businesses has a CRA exam that does not examine the effectiveness of its retail lending in serving low- and moderate-income borrowers?[16]

Regardless of any particular charter that might be granted to FinTech companies, CRA exams must scrutinize retail lending since FinTech companies, by their nature, are geared towards retail consumers. Limited purpose CRA exams focus on community development (CD) lending and qualified investments. While CRA exams should encourage CD lending and investment, they must also examine FinTech firms for what they purport to be, namely retail institutions. To do otherwise would violate the guidelines in the OCC's licensing manual which reiterates a need for

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[14] Lalita Clozel, American Banker, "OCC Weighs New Charter for FinTech Firms" *American Banker*, May 10, 2016.

[15] Some non-bank entities such as mortgage companies or FinTech firms that issue home loans are regulated and would receive consumer compliance ratings. For those that are not regulated and subject to a consumer compliance exam, they could not apply for a federal bank charter until state or federal law changes to require them to be regulated.

[16] See https://www.lendingclub.com/info/statistics.action.

a strong public duty requirement and emphasizes that newly chartered banks must meet, "the credit needs of its entire community, including low-and-moderate income neighborhoods, consistent with the safe and sound operations of the bank."[17]

The OCC, in its white paper, states that it may offer guidance regarding activities that are considered to be innovative in terms of promoting financial inclusion.[18] While NCRC is not opposed to guidance of this nature, NCRC urges the OCC to promote only activities that are "innovative" in a CRA context if they effectively promote financial inclusion to substantial numbers of low- and moderate-income consumers in a responsible fashion. Such judgments cannot be subjective and must be grounded in careful data analysis.

Some have called for exceptions for FinTech firms to the Equal Credit Opportunity Act (ECOA), Fair Credit Reporting Act (FCRA), the Electronic Funds Transfer Act (EFTA), and other consumer protection laws, in so-called pilot experiments to allow FinTech firms time to develop new products. If new products cannot adhere to ECOA and other laws, they should not be introduced into the market. It is not innovative to develop products that result in discrimination or unfair and deceptive practices.

Ultimately, financial institutions will be innovative in serving low- and moderate-income consumers if they operate in a regulatory framework that applies uniform rules rigorously to all types of financial institutions. Financial institutions will then compete based on truly affordable products responsive to credit needs instead of grabbing market shares by promising quick approvals not grounded in careful underwriting or deceptive loan terms that feature adjustable rates that make loans initially affordable but then trap borrowers in unsustainable debt. In the wake of the financial crisis, Dodd-Frank mandated that the CFPB and prudential regulators promulgate the Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) rules that helped level the playing field for mortgage lenders by creating a uniform floor of prudent practices such as not lending beyond a borrower's ability to repay, and ensured that lenders had some "skin in the game" for faulty loan products. Similar rules are needed for FinTech and all other institutions, particularly those in consumer and small business lending.

Some initial efforts have been made to suggest best practices for marketplace lenders. Currently, advocacy organizations have been working with some FinTech companies to develop best practices such as those outlined in the Small Business Borrowers' Bill of Rights.[19] These include transparency and clarity regarding interest rates and loan terms and conditions. However, stronger oversight is required, including action by both regulators and Congress.

Conclusion

[17] OCC, *Charters: Controller's Licensing Manual*, Feb 2009, http://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/charters.pdf

[18] OCC, Supporting Responsible Innovation, p. 8.

[19] See http://www.responsiblebusinesslending.org/

NCRC considers innovation to be a large-scale provision of responsible loans that sustainably respond to credit needs. New technologies and new types of companies could be part of the answer but the romance with innovation should not blind us to the possibility that the new market entrants may not be the long term answer. NCRC believes that high-touch models will still be needed for reaching traditionally underserved populations; this may include counseling agencies partnering with both traditional lenders and FinTech companies. Data will be key to measuring success, creating rigorous enforcement, and public accountability. Only if comprehensive and uniform regulation is adopted and applied to both FinTech and existing companies will a lending marketplace be created that is responsible, efficient, and equitable.

Thank you for the opportunity to testify.