



Main Street Matters

*Ideas for Improving Small
Business Financing*

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BIPARTISAN POLICY CENTER

AUTHORS

Paul Greig

Former Chairman and CEO of FirstMerit Corporation

Karen Mills

*Former Administrator of the U.S. Small
Business Administration*

Olympia Snowe

Former U.S. Senator from Maine

*Former Chair and Ranking Member of the Senate
Committee on Small Business and Entrepreneurship*

Mark Walsh

*Angel Investor and Venture Capitalist,
Ruxton Ventures, LLC*

STAFF

Julie Anderson

Senior Vice President

John Soroushian

Senior Policy Analyst

Dora Engle

Project Coordinator

CONSULTANTS

Justin Schardin

James C. Sivon

Greg Wilson

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DISCLAIMER

The finding and recommendations expressed herein do not necessarily represent the views or opinions of the Bipartisan Policy Center's founders or its board of directors.

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Letter from the Co-Chairs

Small businesses have long held a vaunted place in the U.S. economy and in the American imagination. This isn't surprising because the American project, from the beginning, was entrepreneurial at its core.

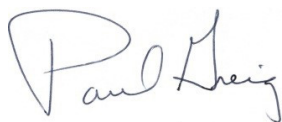
From iconic figures like Benjamin Franklin, who started his own publishing house to provide news services to prerevolutionary Pennsylvania in 1728; to Sam Walton, who opened his first Walmart store in Rogers, Arkansas, in 1962; to Steve Jobs, who founded the Apple Computer Company in a suburban Los Altos, California, garage in 1976, the drive to seize an idea and turn it into reality has always propelled the nation's growth and economic vitality as well as Americans' collective sense of identity. In short, the story of Main Street realizing vast success and generating wealth has been integral to the larger story of the United States and of the limitless possibilities it holds.

We are enthusiastic advocates of this story because small businesses—even those that don't grow into a Walmart or Apple—provide a critical path to economic mobility and security that is available across all regions of the country. The United States is a global leader in innovation and economic dynamism, both of which are driven in large part by start-ups and small firms. High-growth small businesses develop new ideas that support a vital U.S. economy, while Main Street small businesses provide stability and cohesion in communities and support a strong middle class. Starting a small business, creating something new, and taking charge of one's own economic destiny remains a dream for countless Americans, regardless of background or circumstances—and we are all stakeholders in nurturing that dream.

And yet, there is evidence that it is becoming more difficult to start and maintain a small business in the United States. Entrepreneurship has been slowly declining in recent decades, with the share of new firms in the U.S. economy decreasing since the 1970s. More recently, the Great Recession hit small enterprises hard, and lending to small firms has recovered more slowly than lending to large firms. The challenge of accessing capital is especially pronounced for entrepreneurs seeking loans of \$250,000 or less. Small operations located in rural areas and women- and minority-owned firms have an even harder time accessing financing.

Fortunately, support for small businesses is a rare oasis of bipartisan consensus, among politicians and in the broader public. According to a Gallup poll, roughly 70 percent of Americans have a lot of confidence in small businesses. And in Washington, members of both parties regularly express concern about the health of small businesses and an interest in policies that support them.

Given our backgrounds—a former head of the Small Business Administration and cabinet member; a former U.S. senator and chair of the Senate Small Business Committee; a former bank CEO; and a former head of the Small Business Administration's Office of Investment and Innovation and current angel investor—we share a keen interest in ensuring that the nation continues to provide unparalleled opportunities for small businesses and entrepreneurs to thrive in. This report describes what we have learned in speaking with a wide range of experts on small business financing, including current and former regulators, academics, traditional banks, financial technology companies, other providers of capital, entrepreneurs, and small business advocates. We offer an agenda of pragmatic recommendations to make the financial system work better for small businesses and entrepreneurs that we are confident can secure bipartisan support.



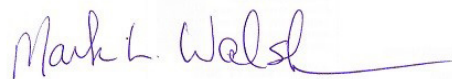
Paul Greig



Karen Mills



Olympia Snowe



Mark Walsh

Summary of Recommendations

Section I. Improving Data on Small Business Financing

- Congress should move the collection and storage of small business lending data required under the Dodd-Frank Act from the Consumer Financial Protection Bureau (CFPB) to the Office of Financial Research (OFR).
- Congress should mandate that the Office of Advocacy in the Small Business Administration (SBA) work with the OFR to review and publish assessments of the data collected.
- The CFPB should implement the Dodd-Frank Act's data-collection provisions in stages, beginning with loan-origination data already collected by lenders.
- The Internal Revenue Service (IRS) should make small business tax data available to researchers.
- The SBA should digitize, aggregate, and anonymize select data from the Small Business Investment Company (SBIC) and Small Business Innovation Research (SBIR) programs and make the data available to SBA-approved entities.
- Congress should require the IRS to update its Income Verification Express Service (IVES) program to allow for faster access to summarized income tax information for loan applications; Congress should grant the IRS the authority to pay for this update by collecting reasonable fees from investors and lenders.

Section II. Recalibrating Financial Regulation

- Congress should establish a national commission to conduct a comprehensive review of financial laws and regulations.
- Congress should establish a pilot program to test the efficacy of coordinated bank examination teams.
- Congress should subject additional financial regulatory agencies to the Small Business Regulatory Enforcement Fairness Act (SBREFA) process, which mandates consultation with small businesses for certain rulemaking processes.
- Financial regulatory agencies should update their definitions of a lender's Community Reinvestment Act (CRA) assessment area to account for recent innovations in banking.
- Regulators should ensure that their CRA regulations and supervisory practices encourage small business lending and investment to the same degree that they encourage other kinds of CRA lending and investments.
- The U.S. Treasury Department should undertake a comprehensive review of anti-money laundering rules to assess the costs of implementation and recommend ways to reduce their negative impact on lending.
- The federal prudential bank regulatory agencies should issue joint guidance to encourage innovation that will better and more efficiently detect money laundering and terrorism financing.
- The CFPB should adjust and clarify its qualified mortgage and ability-to-repay rules to better reflect the circumstances of small business borrowers who may not have a steady source of income.
- The SBA should build off the success of the QuickPay program to reduce the amount of time it takes federal small business contractors to get paid.
- While the Co-chairs have a range of opinions about the institutions to which this should apply, Congress should direct the Federal Trade Commission (FTC) to develop a simple disclosure form for loans and advances to small businesses.^a
- The federal banking agencies and the Federal Trade Commission should jointly assess whether small business borrowers find it difficult to understand the terms of the loan documents.^a
- Congress should amend the Fair Debt Collection Practices Act to apply to debts incurred by small businesses with less than \$500,000 in annual revenue.

^a Please see Appendix A for expanded co-chair views on this recommendation.

Section III. Making U.S. Capital Markets Work Better for Small Businesses

- The Securities and Exchange Commission (SEC) should review Regulation CF to identify ways to make it more effectively support crowdfunding campaigns, assess the costs and benefits of collecting more data, and analyze disparities in crowdfunding among different demographic groups.
- Congress should give the SEC the authority to raise the cap on how much wealthier individuals can invest in crowdfunding campaigns.
- The SBA should work with small business mentoring and training partners to identify gaps in these types of services to small businesses and take steps to improve access, including ensuring the agency and its partners are maximizing technology and e-learning strategies.
- SBA district offices should further partner with regional business accelerators and incubators to improve access to business resources and venture capital funding.

Section IV. Promoting Innovation and Integrating Technology

- Federal and state financial regulatory agencies should establish technology and innovation offices. Each office should create a “greenhouse” to work in partnership with the private sector to use technology to promote responsible financial innovation with prudent risk management.
- Congress should amend the National Bank Act to authorize the Office of the Comptroller of Currency (OCC) to issue a federal charter for nonbank financial companies.
- States should continue to work together through the Conference of State Bank Supervisors to harmonize requirements, supervision, and coordination for nonbanks operating in multiple states.
- Federal bank regulatory agencies working through the Federal Financial Institutions Examination Council (FFIEC) should develop joint guidance for third-party vendor management.
- The FFIEC should develop a common standard to certify when vendors have complied with third-party guidelines.

Introduction

The Bipartisan Policy Center established the Task Force on Main Street Finance to find ways to make the financial system work better for small businesses and entrepreneurs, which are critical components of the U.S. economy. The task force focused on four key questions:

1. What kinds of data would help policymakers, researchers, and lenders to better understand small business financing, including potential inequities in the provision of small business credit, and how could that data best be collected and assessed?
2. How do financial regulations, especially those put into place following the 2007-2008 financial crisis, impact small business lending, and is there room for improvement?
3. Can capital markets better provide financing to small businesses?
4. How is technology changing the provision of credit to small businesses, and how should the government respond to these changes?

The report starts with background and context on the importance of small businesses to the U.S. economy as well as recent trends in small business health and access to credit. The first section discusses ways to improve the quality and quantity of data available on small business financing. Good data are necessary both to improve credit-application processes and to enable lawmakers and regulators to make better-informed decisions when developing government policy. The second section reviews financial regulation that impacts access to credit for small businesses and recommends ways to recalibrate regulations to make them more efficient and effective. The third section delves into how to make U.S. capital markets work better for small businesses. The final section sets forth ideas on how policymakers can promote innovation in financial products and services and better integrate technology into financial markets.

Background and Context

The Importance of Small Businesses and Financing

Small businesses are a critical part of the economic foundation of the United States.¹ They are an important source of job creation and creative dynamism that keep the U.S. economy vibrant and growing. Small firms employ close to half of the private-sector workforce and have created nearly two-thirds of the net new jobs in the U.S. economy from 1993 to 2016.^{2,3} Small businesses also punch above their weight when it comes to innovation, producing a disproportionate share of patents.⁴

But small businesses are important for more than economic reasons. They are a source of stability for society, supporting a vibrant middle class. Small enterprises create jobs that tie them to the communities in which they operate. They offer opportunities for independence and flexibility. And they have long been a focus of the American Dream: Immigrants have higher rates of entrepreneurship than the U.S. population as a whole.⁵

Financing makes the small business ecosystem function. Small enterprises need access to funding to grow, to manage cash flow, and to weather inevitable ups and downs. But there are different kinds of small businesses, each with different financing needs.⁶ Perhaps the two types of small businesses most people recognize are Main Street enterprises (such as local coffee shops, insurance agencies, and gift stores) and high-growth start-ups (such as the ones that dominate Silicon Valley). However, the largest category of small businesses is non-employer firms, otherwise known as sole proprietorships, which include consultants, independent contractors, and freelancers. A fourth category is supply chain firms that serve other businesses.

Each of these operations has different financing needs. A Main Street small business may need a bank loan to open a second location or to replace its computer system, or it may require a line of credit to smooth out fluctuations in revenue. A high-growth start-up may be better suited by an equity investment from a venture capital firm with an eye toward long-term expansion. For each type of small enterprise, however, access to capital on fair and competitive terms and conditions is a critical element of success. An analysis by the National Small Business Association, which examined data from 1993 to 2016, found a correlation between small business owners' ability to hire and their access to credit. Funding allows for expansion and job creation, and the same study found that a lack of credit access can mean stagnation or even a reduction in employment or benefits.⁷

Evidence from the Federal Reserve's 2016 Small Business Credit Survey found that the small businesses surveyed cited credit availability or securing funds for expansion as the top financial challenge they faced. In addition, the report found that 60 percent of small businesses that applied for financing in the prior year reported a financing shortfall and that small firms received a lesser share of the financing they applied for than larger firms with similar credit quality.⁸

Trends in Small Businesses and Small Business Financing

Businesses always suffer during an economic downturn. During the Great Recession, small businesses suffered more than other kinds of businesses and have been slower to recover than in previous recessions. According to analysis by Goldman Sachs, as of 2015, the Great Recession resulted in 675,000 more "missing" small businesses than past trends would predict and a shortfall larger than any other since data on the number of U.S. small businesses became available in the 1970s.⁹ A report from the U.S. Treasury Department shows that the recovery of bank lending after the Great Recession was slower than in any of the previous seven economic recoveries and that the recovery in lending has been especially slow for small firms.¹⁰

Small businesses suffered disproportionately from the Great Recession, but there are longer-term trends that are cause for concern as well. While the total value of small business loans increased steadily from 1995 to just prior to the recession, the ratio of small business loans to total loans dropped from 34 percent to 28 percent.¹¹ After a brief uptick in that ratio during the crisis, it fell further to 20 percent by 2015.

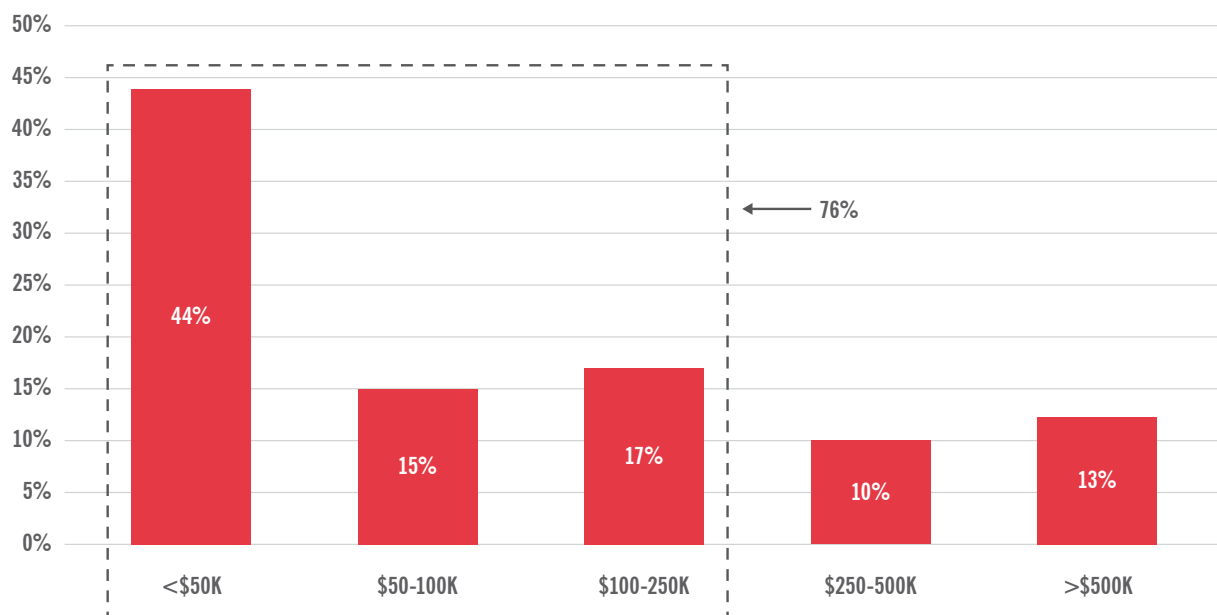
It is unclear what has caused these trends, but there are several possible reasons. One is that there are fewer new businesses that require traditional financing. The number of new firms (those less than one year old) as a percentage of all U.S. firms dropped by more than half between 1977 and 2013.¹² It is a bit of a chicken-and-egg issue: Did the decline in start-ups reduce the need for small business loans, did increased difficulty in

accessing credit for start-ups cause their numbers to drop, or was it a combination of both? Other potential contributors to the drop in small business lending include a 34-year decline in the number of smaller community banks,¹³ which traditionally have been more likely to lend to small firms;¹⁴ changes in bank regulation that make it more difficult and less profitable to lend to smaller operations; and structural changes to the U.S. economy.

Another important factor is that many traditional lenders are limiting their small-dollar business loans, often placing a cut-off point at \$100,000 or \$250,000. The primary reason is that the costs of underwriting a loan do not scale with the size of the loan. That means lenders generally find larger loans more profitable than smaller ones. Unfortunately, as Figure 1 indicates, small-dollar loans are the ones that most small businesses need. Recent research demonstrates the salience of this small-dollar loan gap.¹⁵

Figure 1. Small Businesses Want Small Dollar Loans

Percentage of Applications from Small Businesses by Loan Size



Source: Mills and McCarthy, “The State of Small Business Lending: Innovation and Technology and the Implications for Regulation,” 2016;¹⁶ Federal Reserve of New York, Fall 2013 Small Business Credit Survey, 2013.¹⁷

Demographics also play a critical role. Women- and minority-owned businesses have continued to grow but have had trouble accessing adequate financing.¹⁸ Recent studies have shown that women who own businesses may be more reluctant than men to apply for credit because they fear that banks will deny their loan applications.¹⁹ Similarly, a study for the U.S. Department of Commerce found that minority-owned firms were less likely to receive credit than non-minority-owned businesses.²⁰

Fortunately, despite the current polarized political environment, there is room for progress. Each district and state in the country—whether red, blue, or purple—has many small businesses. And the public strongly supports small enterprises. According to a 2017 Gallup poll, more than two-thirds of Americans have a “great deal” or “quite a lot” of confidence in small businesses as an institution, which is significantly greater than their confidence in the media, political institutions, large businesses, or every other major institution polled except for the police and the military.²¹

Small business lending has changed in recent years and continues to change with innovations in financial technology. But its pivotal role has not changed: Entrepreneurs still require money to create jobs and to maximize America’s economic potential. Smart policy—better policy—is achievable and will help finance Main Street growth and ensure the American Dream continues to be a reality for all.

Section I. Improving Data on Small Business Financing

New technology has made data more abundant and accessible than in any time in history. This abundance has affected all aspects of the economy, from advertising to inventory management to finance. Smart public policy can ensure that policymakers and the financial system use this data more efficiently to benefit small businesses.

In the current polarized political environment, many are distrustful of the U.S. government and its institutions. Evidence-based policymaking—the process by which evidence informs decisions about government policies and programs—has the potential to restore public trust in the government.

Without systematically collecting data and subjecting it to rigorous and objective analysis, it is difficult to know how well policies are working. Evidence about whether a policy or program was implemented effectively, has achieved its intended outcomes, or has resulted in unintended consequences is essential to responsibly spending taxpayer funds and improving existing policy.



The 2007-2008 financial crisis underscored that policymakers lack sufficient evidence and data on small business lending.

The 2007-2008 financial crisis underscored that policymakers lack sufficient evidence and data on small business lending. Banks report a great deal of data to financial regulators, but to this day, the government does not collect data on the origination of small business loans. The best data currently available on small business lending is the stock of commercial and industrial loans of under \$1 million, which the Federal Deposit Insurance Corporation (FDIC) provides. While this metric is helpful, it includes some loans to larger firms that can leave policymakers with an incomplete picture of conditions in small business credit markets.

In addition to informing federal and state policymakers, improving the quality and accessibility of data on small business financing would create numerous benefits for small businesses. For example, many small businesses have a limited track record of performance, keep incomplete business records, or are otherwise informationally opaque to lenders. This lack of information makes it harder for banks to assess the risk involved in making loans to these businesses. Banks may try to resolve this lack of information by conducting extra due diligence on borrowers. But in either case—uncertainty or the extra costs of due diligence—loans become more expensive to underwrite and hence may be unaffordable for the borrower. Better data about individual businesses could provide lenders with the information to better assess risk and likely decrease the price of credit. The ability to more easily share data would also reduce paperwork and transaction costs when applying for credit. Researchers and investors could assess the factors that go into creating a successful small business, knowledge that would provide guidance for entrepreneurs as well.

Recommendations

Collect Better Data on Small Business Financing

- Congress should move the collection and storage of small business lending data required under the Dodd-Frank Act from the Consumer Financial Protection Bureau (CFPB) to the Office of Financial Research (OFR).
- Congress should mandate that the Office of Advocacy in the Small Business Administration (SBA) work with the OFR to review and publish assessments of the data collected.
- The CFPB should implement the Dodd-Frank Act's data-collection provisions in stages, beginning with loan-origination data already collected by lenders.



Since the Great Recession, there has been a greater appreciation for the need for data on small businesses and small business lending. Congress authorized the newly created CFPB to collect and assess data on small business lending in Section 1071 of the Dodd-Frank Act. This provision requires financial firms to report a range of small business loan information, including:

- The dates of loan or other small business credit applications;
- The type and purpose of the credit applied for;
- Whether the application was approved or denied; and
- The amount of credit applied for and approved.

Dodd-Frank also requires the agency to collect information on:

- The census tract in which the principal place of business is located;
- The race, sex, and ethnicity of the principal owners of small business applicants; and
- The gross annual revenue of the business.

The purpose of collecting this information is to permit the CFPB to monitor and enforce fair lending and to help policymakers identify needs and opportunities for small businesses and women- and minority-owned firms.

Although the CFPB stated in 2011 that it would act “expeditiously” to develop rules to implement Section 1071,²² it was not until 2017 that the agency released an official request for information to help them develop the rules.²³ While Acting CFPB Director Mick Mulvaney has noted that the agency is required to implement the provision, he believes it will be difficult to execute and has not specified a time line for finalizing rules.²⁴

There are several reasons the provision has been challenging to implement. First, lenders state that cumulative compliance burdens substantially increased following the crisis and that reporting on small business lending will require additional costly changes to internal systems. For example, banks currently do not collect information on whether a small business applicant for credit is principally owned by women or minorities. Lenders also question whether the cost/benefit analysis justifies additional system changes.

Second, there is concern about how the CFPB might use data on women- and minority-owned businesses. Following the passage of Dodd-Frank, the fledgling CFPB made clear that it would judge compliance with the fair-lending requirements of the Equal Credit Opportunity Act to include not just whether lenders treated all groups of potential borrowers fairly, but also whether the *impact* of lending practices had different effects on protected demographic groups.²⁵ This doctrine of “disparate impact” resulted in controversial enforcement actions on the part of the CFPB against lenders, who criticized the agency for basing these actions on statistical outcomes rather than discriminatory intent on the part of lenders.

This experience has made lenders wary of collecting data on women- and minority-owned small businesses—a data set that does not exist today. A white paper by the American Bankers Association argued that the potential cost and reputational risks to lenders of disparate impact would result in lending becoming “more standardized and defensive, less tailored, and some programs or services are discontinued.”²⁶

Nevertheless, having this kind of data available is important, so we offer three recommendations aimed at collecting this data while mitigating concerns:

1. Congress should amend Dodd-Frank so that a third party, rather than the CFPB, collects and stores the small business data required under Section 1071. The third party would anonymize the data collected and aggregate it so that policymakers, including the CFPB, could use it to develop better policy. The CFPB would not have access to data on individual lenders.

The entity authorized to collect this information should have experience with collecting and storing data, guarding its privacy, and assessing and disseminating the data effectively. We recommend the OFR collect and store this data because it has the capacity and expertise to collect and analyze large financial data sets and does not have enforcement authorities.

2. Congress should mandate that the OFR work with the SBA's Office of Advocacy to review and publish assessments of the data collected. These assessments should include analyzing trends in the data and providing policymakers with insights and recommendations to improve lending outcomes for small businesses. The Office of Advocacy will bring to bear a specialized knowledge of small business policy and experience in presenting data effectively.
3. Until Congress acts on the two previous recommendations, the CFPB should work to implement Section 1071 in stages, beginning with collecting most easily reported data. Banks already collect loan-origination data, such as the amounts requested in loan applications, application dates, and decisions on whether applications were approved or denied. While reporting this information to regulators will involve additional compliance, because the data have already been collected, it would be relatively straightforward and potentially realize benefits far beyond the costs. The CFPB should implement this provision in a way that minimizes data-collection burdens but that still collects the data necessary to properly inform policymakers as soon as is practical.

Women-Owned Small Businesses

The data collected through Section 1071 of the Dodd-Frank Act will be a complement to existing small business surveys. While this data will not be as comprehensive as the loan-level data from Section 1071, the small business surveys ask targeted questions that can help policymakers better understand the challenges these businesses face. This can be especially helpful in understanding the needs of specific groups, such as women-owned, minority-owned, and rural small businesses. For instance, the Federal Reserve's new survey on women-owned small businesses with at least one non-owner employee has some interesting insights that policymakers and researchers could explore further with better data.²⁷

- **Women-owned small businesses report funding gaps more often:** 64 percent of women-owned small businesses reported a funding gap (meaning they received "some" or "none" of the financing they sought), compared with 56 percent of men-owned small businesses.
- **Women-owned small businesses are less likely to use external financing:** Only 12 percent of women-owned small businesses use external financing as a primary source of funding, compared with 16 percent of men-owned small businesses.
- **Women-owned small businesses tend to be smaller and younger:** 22 percent of women-owned small businesses have revenues of \$1 million or more compared with 36 percent of men-owned small businesses. Among women-owned small businesses, 37 percent have been in operation five years or fewer, compared with 32 percent of men-owned small businesses.

Digitize and Publish Existing Government Data

- **The Internal Revenue Service (IRS) should make small business tax data available to researchers.**

In 1987, a minor change in Congress's landmark 1986 tax legislation required filers to list the Social Security numbers of any dependents they claimed. Congress included the provision to stop taxpayers from claiming fake dependents to reduce their tax burden, and it had the intended effect.

Twenty-four years later, economists Raj Chetty and Emmanuel Saez realized that the 1987 modification would allow them to track the tax filings of individuals over time: where they lived, their incomes, and more. These data would allow the researchers to assess how factors individuals faced in childhood may have affected their adult lives. Since the analyses required were complex and involved sensitive information, the two economists relocated from their universities to Washington, D.C., conducting the research under similar security measures as regular IRS employees.²⁸

Their work revolutionized how researchers understand social mobility in the United States. Among their conclusions, they determined that mobility was highly correlated with where children grew up and that geographic areas with high mobility tend to have less segregation and inequality, better schools, and greater social capital and family stability.²⁹ Chetty and Saez have followed up on their initial work with several additional studies on equality of opportunity.

This example provides two useful lessons. First, basic IRS data on small businesses could yield important insights for policymakers and other key stakeholders. Second, there are methodologies and protocols in place to make accessing this type of data more secure.

- **The SBA should digitize, aggregate, and anonymize select data from the Small Business Investment Company (SBIC) and Small Business Innovation Research (SBIR) programs and make the data available to SBA-approved entities.**

The SBA has several divisions and programs that facilitate access to non-debt capital for U.S. small businesses. Two of these programs are the SBIC and the SBIR.

The SBA created the SBIC program in 1958 to facilitate the flow of long-term capital to U.S. small businesses. SBICs are privately managed firms that use a combination of their own capital and funds borrowed with the backing of an SBA guarantee to make investments in qualifying small businesses. As of 2016, there were 313 licensed SBICs managing about \$28 billion in assets that provided about \$6 billion in funding to 1,200 small businesses in the previous year.³⁰ The SBA created the SBIR program in 1982 to help spur innovation by encouraging U.S. small businesses to engage in federal research and development that has commercial potential. In fiscal year 2015, SBIR and its sister program, Small Business Technology Transfer, together provided about \$2.5 billion in grants and contracts across several federal agencies.³¹

Both programs collect data on the size, location, structure, industry, number of employees, growth, and performance of the companies invested in with SBA-backed funding. This is a rich record of small business success factors and performance information that would be useful to all the individuals and entities involved in the process of funding these companies. Likewise, data on company growth and outcomes would be valuable to members of the policymaking, investment, venture capital, private equity, banking, and analyst communities.

Despite its potential value, the SBA maintains many of these records in antiquated formats such as printed reports and does not share the information with entities outside the SBA. If the SBA digitized, aggregated, and anonymized data from the SBIC and the SBIR programs, they could provide value to stakeholders trying to better understand the nexus of finance and innovation and thereby better serve the economy.

The SBA would only make data in this anonymized form available to SBA-approved entities that meet privacy protection and other standards that the SBA administrator would need to establish. Understanding that establishing standards and making the data available to approved entities will require resources, the SBA should consider collecting a reasonable fee from the end users of this data.

Streamline Credit Application Processes

- **Congress should require the IRS to update its Income Verification Express Service (IVES) program to allow for faster access to summarized income tax information for loan applications; Congress should grant the IRS the authority to pay for this update by collecting reasonable fees from investors and lenders.**

When a consumer or small business applies for a loan, they provide a signed form that allows the lender to access a summarized version of their tax transcripts from the IRS. This allows lenders to verify the assets and income of potential borrowers to determine whether these borrowers are likely to repay their loans.

The IVES program handles these requests. Unfortunately, the IRS has not updated IVES to take advantage of innovations that could substantially speed up the process, thereby allowing lenders to make decisions faster and small businesses to get access to funding faster. The IRS reports that IVES generally processes loan applications within two to three business days,³² but the process can take significantly longer.

While the IRS would need to ensure that private information is appropriately safeguarded, greater automation should save significant time, money, and paperwork for everyone involved in the loan application and verification process. In a 2016 report, the U.S. Treasury Department recommended automation of IVES, saying that in addition to reducing wait times and costs, it would “facilitate compliance with consumer protection rules regarding the verification of borrowers’ ability to pay; and potentially expand access to credit.”³³

In addition, there is bipartisan support in Congress. Legislation that has passed the House and is pending in the Senate would require the IRS to automate the IVES system to make it accessible over the internet in as close to real-time as is feasible. The IRS would be able to pay for upgrading IVES by assessing fees for disclosures obtained through the new system. The ability to assess fees would mitigate any IRS concerns about having to make cuts elsewhere in its budget.

While the IRS does not need new authority to upgrade the IVES program, IRS staff and resources are constrained. New authority that includes explicit direction to assess a fee that reflects a reasonable market value to lenders and funds the upgrade and ongoing maintenance is ideal. The IRS should try to design its assessment schedule to reflect a reasonable market value to lenders for the new improvements.



Section II. Recalibrating Financial Regulation

Following the 2007-2008 financial crisis, there was broad consensus that U.S. financial regulatory reform was necessary. In the preceding years, too many financial firms had left themselves vulnerable to even modest economic downturns. Perverse incentives and inadequate supervision had led to the proliferation of toxic mortgages that borrowers were unlikely to be able to repay. A lack of oversight of an exploding market for complex financial products known as derivatives had left regulators and market participants blind to the risk building in the system. Complicating this situation was a fragmented U.S. regulatory structure that lacked the data and coordination necessary to comprehensively understand systemic risk.

The Dodd-Frank Act and other post-crisis reforms such as new and updated international standards attempted to address these and other problems. A 2016 BPC analysis found that, in general, post-crisis financial regulatory reforms have made the financial system safer and have better protected consumers from risky financial products. Not surprisingly, however, the Dodd-Frank Act also has led to some unintended consequences, including restraints on credit to small businesses, and the law did not address every underlying issue, such as the fragmentation of the regulatory structure.³⁴

In the past, Congress followed its financial reform efforts—such as the legislation passed following the Great Depression and after the savings and loan crisis of the 1980s and 1990s—by enacting technical bills to adjust to how that legislation worked in the real world. Congress took bipartisan action earlier this year to address some of the unintended consequences of the Dodd-Frank Act. However, there is still more to do.

Specifically, our task force focused narrowly on unintended consequences of regulatory reforms on the willingness and ability of lenders to extend credit to small businesses. The recommendations in this section will build on what post-crisis reforms have achieved and will address unintended consequences that in some cases have made it more difficult for small enterprises to access capital.

Recommendations

Review Post-Crisis Regulation

- **Congress should establish a national commission to conduct a comprehensive review of financial laws and regulations.**

In G20 countries, several efforts are underway to assess the results of post-crisis financial regulatory reforms. In 2015, the European Commission issued a call for evidence on the impact of new financial regulations to help determine whether it should take more action to promote economic growth and job creation within the European Union.³⁵ More broadly, the G20 has recently focused on achieving balance in financial regulation. In 2016, its leaders released a statement that underscored how important financial stability is to economic growth, but they also acknowledged the need to understand and address any unintended consequences of financial reform.³⁶

In recent months, the United States has begun a more comprehensive review of post-crisis regulations. In response to an executive order from President Donald Trump,³⁷ the U.S. Treasury Department has released a series of reports on how to improve financial regulation. The department has placed a special emphasis on gauging the impact of rules on small enterprises. The first of its reports, on bank and credit union regulation, included a version of the phrase “small business” 83 times in its 147 pages.³⁸

Independent regulatory agencies also are conducting assessments. The first vice chairman for supervision at the Federal Reserve Board, Randal Quarles, has embarked on a review of the U.S. financial regulatory framework that will assess the effectiveness, efficiency, transparency, and simplicity of financial rules and regulations, including a review of potential unintended consequences.³⁹ Comptroller of the Currency Joseph Otting has laid out a reform agenda that includes rethinking the Community Reinvestment Act and anti-money laundering rules.⁴⁰ And just this year, the CFPB has issued 12 separate calls for evidence to review its processes and programs.⁴¹

While such reviews can be productive, they have certain limitations. First, due to the fragmented nature of the U.S. financial regulatory structure, it can be difficult for individual agencies to see or coordinate outside of their jurisdictions even though many rules and regulations are the responsibility of multiple agencies or overlap with the rules of other agencies. The Financial Stability Oversight Council (FSOC) can and should play a role in compensating for this fragmentation, as it has a statutory duty to help coordinate among its member agencies.⁴² However, even the council’s authority has limits, and its focus is on systemic risk rather than on financial regulation more broadly.

Second, internal assessments can be subject to groupthink and the inertia of the existing bureaucracy. An independent review of the financial regulatory framework would provide a different perspective and a valuable complement to the agencies' own analyses.

There are models of this type of commission in several other countries that are informative. For example, Canada has a rigorous process to review its financial sector's legislative and regulatory framework every five years to ensure that the financial institutions doing business there are serving Canadian customers of all types well. Canada's Bank Act and related laws sunset on a recurring basis; currently, they are scheduled to expire in 2019.

Most recently, the Canadian Department of Finance is overseeing a review and ultimately will report its findings to the Parliament. The department solicits all stakeholder views through a deliberative, inclusive process. It considers the core financial-sector policy objectives of stability, efficiency, and utility—the ability to meet the needs of Canadian customers—to ensure a well-functioning financial framework to support a strong, growing, and inclusive economy.⁴³

To meet U.S. policy objectives, Congress should establish an independent commission, the key elements of which should include:

- Drawing members of the commission from a diverse range of perspectives, including former regulators, representatives of financial firms, consumer and small business advocates, and academics;
- Seeking insights and recommendations from additional experts in those same categories;
- Being bipartisan in its makeup;
- Formulating recommendations that will best balance the U.S. financial regulatory framework with promoting economic growth; maintaining financial stability; and protecting consumers, businesses, and investors; and
- Developing recommendations to improve the financial regulatory system, and including those that two-thirds of its members agree to in a report to Congress.

Key questions a commission might consider include:

- Are consumers, small and large businesses, and investors well served by the current financial regulatory framework and rules? Do consumers and other potential borrowers have access to affordable credit? What are the economic costs and benefits of regulation, including the impact on access to credit?
- How are different groups of consumers, businesses, and investors being affected differently by financial regulation, and can policymakers make changes to ameliorate any significant negative effects?
- Are there rules that are unnecessarily duplicative, in conflict with each other, or otherwise causing unintended negative consequences?
- Are there significant gaps in regulation?
- Does the U.S. financial regulatory structure unnecessarily limit coordination among regulatory agencies or otherwise result in less-than-optimal outcomes?
- Do policymakers have the data and tools they need to assess (quantitatively and qualitatively) stability, growth, and the needs of consumers, businesses, and investors? Are they encouraged to do so?
- Do regulators have the data and tools necessary to address risky activities, particularly outside of the regulated banking sector?
- To what extent can the commission empirically measure the costs and benefits of regulation, and when is it appropriate to conduct a cost-benefit analysis?

The commission should assess how well the financial system serves U.S. small businesses. It should review and make recommendations where appropriate on topics such as:

- The availability of credit in rural communities and for women- and minority-owned businesses;

- The degree to which small business lending decisions are made via the automation of processes based on objective metrics, or using so-called “relationship lending,” and the advantages and disadvantages of each; and
- The causes and impacts of the decline in the number of community banks on small business lending.

Address Fragmentation in the Regulatory System

- **Congress should establish a pilot program to test the efficacy of coordinated bank examination teams.**

The fragmentation of the U.S. financial regulatory system adds unnecessary costs to lenders and other financial firms that increase costs for small businesses. The U.S. financial regulatory system lacks a coherent design and has instead evolved over time—often in reaction to financial crises. Currently, the U.S. system features three different federal bank regulators, two capital markets regulators, and bank and securities regulators in each state. This fragmented structure leads to overlapping jurisdictions, duplication of functions across multiple agencies, and gaps in oversight. Fragmentation also can be difficult for financial institutions, which multiple agencies often examine at once, each with its own timetable and process. The net effect is an inefficient regulatory system that passes costs on to small businesses.

Although many experts over the years have proposed consolidating agencies to create a more coherent regulatory structure,⁴⁴ doing so has proved to be politically difficult. Instead, past financial crises have generally resulted in Congress creating at least one new regulatory agency. After the most recent crisis, Dodd-Frank did eliminate one agency—the Office of Thrift Supervision, which had jurisdiction over several of the key financial firms that failed in 2008—but it created three others: the CFPB, the FSOC, and the OFR.

Congress could achieve many of the benefits of consolidation in a more politically feasible way by creating coordinated examination teams made up of representatives from multiple agencies. We recommend that Congress establish a pilot program to test the feasibility of coordinated examination teams.

Coordinated examination teams would include bank examiners from each federal prudential regulatory agency that already has jurisdiction over a specific financial institution. For example, an examination team for a hypothetical mid-sized national bank would include examiners from the Office of the Comptroller of the Currency (OCC), which is the primary regulator for all national banks; the Federal Reserve, which oversees bank holding companies; and the FDIC, which oversees the Deposit Insurance Fund that guarantees the bank’s deposits. The bank’s primary regulator, in this case the OCC, would lead the teams. The pilot program should encourage the federal agencies to invite state bank regulators with jurisdiction for the bank in question to participate on the teams if the state regulatory agency so chooses.

The coordinated teams would come together to formulate a single set of examination questions to pose to the bank and would jointly write the examination report. Each participating agency would have access to the report and supporting data. For the pilot program, we suggest that the Federal Financial Institutions Examination Council (FFIEC), an existing body created to coordinate principles, standards, and report forms among its member financial regulatory agencies, coordinate the effort. The FFIEC should work with the Conference of State Bank Supervisors (CSBS) to identify a set of trial examinations for consolidated teams. The pilot should include examinations of banks of different sizes, charters, and levels of complexity; involve a range of expertise from different participating agencies; have sufficient personnel and resources from participating agencies to conduct effective examinations; and additional criteria that will ensure a thorough test of the coordinated team concept.

Such a program would be a win-win-win for all stakeholders, including small businesses. The quality of supervision would increase with better coordination from regulators. Banks would benefit from reducing unnecessary regulatory cost burdens and a single point of contact for communications with examiners. Federal regulators would have better incentives to share insights and information, while examinations would be less expensive due to reduced duplication. Examiners would have access to a wider variety of resources and career options by working with other agencies. State regulators that chose to participate would gain access to specialized expertise and resources that they typically cannot afford to employ. Most importantly, small businesses would benefit from a more efficient financial system that can more effectively extend them credit. Less cost to lenders and less management time dedicated to multiple/duplicative exams would mean more financial resources would be available to support small businesses and more management time would be available to encourage small business lending.

Ensure Small Businesses a Seat at the Rulemaking Table

- **Congress should subject additional financial regulatory agencies to the Small Business Regulatory Enforcement Fairness Act (SBREFA) process, which mandates consultation with small businesses for certain rulemaking processes.**

The CFPB is one of three federal agencies,⁴⁵ and the only financial regulatory agency, required to set up review panels under the SBREFA. The purpose of a SBREFA panel is to gather input from small entities—including businesses, nonprofits, and governmental jurisdictions—early in the rulemaking process. Specifically, when the CFPB determines that one of its rulemakings is likely to have a substantial economic impact on small entities, it must convene a SBREFA panel before it issues a proposed rule for public comment. The law that established the SBREFA process allows for judicial review of agency decisions based on whether the agency adequately considered the disparate impact that proposed rules and regulations are likely to have on small businesses.⁴⁶

When a SBREFA panel is required,⁴⁷ the bureau selects an appropriate mix of people to represent small entities that are likely to be affected to compose the panel, provides them with background information on the proposed rule and alternatives under consideration, and gathers their input at one or more panel meetings. The SBA's Office of Advocacy and the Office of Information and Regulatory Affairs at the Office of Management and Budget also participate in the panels.

A 2016 Government Accountability Office (GAO) study of the CFPB's SBREFA panels found that, although the small-entity representatives that participated in them believed the panels could be improved, most found them useful.⁴⁸ Moreover, the GAO found that engaging early with groups that are likely to be significantly affected by final rules improved the rulemaking process.

Other financial regulators should also ensure a seat at the table for small entities. Specifically, we recommend that the three federal banking agencies and the National Credit Union Administration be subject to the requirement to convene SBREFA panels when its rules are likely to have a substantial economic impact on small entities. The SBREFA panels should act as expeditiously as practicable to ensure that the rulemaking process is not unnecessarily delayed.

Enhance Small Business Lending and Investment through the Community Reinvestment Act

- **Financial regulatory agencies should update their definitions of a lender's Community Reinvestment Act (CRA) assessment area to account for recent innovations in banking.**

Enacted in 1977, policymakers designed the CRA to require lenders to meet the credit and deposit needs of the communities—including both individuals and businesses—in which they are located.⁴⁹ The CRA was a response to the practice of redlining, where lines would be drawn on maps, typically to mark low-income neighborhoods as areas to avoid lending due to higher risk. Since these neighborhoods were often disproportionately populated by minorities, the effect was to reduce credit opportunities for these communities. To that end, the CRA specified that serving community credit needs should specifically include low- and moderate-income (LMI) neighborhoods. In 1995, policymakers modified the CRA to also monitor the provision of credit to small businesses.⁵⁰

Bank examiners periodically review how well lenders are meeting these needs within banks' "assessment areas," which are the areas in which banks have branches and take deposits. Bank examiners review banks on their lending to LMI areas and for making investments and engaging in services in LMI areas. They receive grades ranging from "outstanding" to "substantial noncompliance" that affect the likelihood that regulators will approve an application for sale, merger, or acquisition by a specific bank; grades may also affect the bank's reputation.

Although it is difficult to measure the CRA's impact on LMI communities, studies suggest it has been positive.⁵¹ However, the costs of complying with the CRA are an ongoing source of concern for lenders.

There is increasing awareness that the CRA needs updating. Since Congress passed the CRA, the business of banking has undergone substantial changes. In 1977, for example, there were well over 10,000 banks in the United States. This was largely because banks were not allowed to own branches in multiple states, which kept the number of banks artificially high. Today, branching is allowed and other factors such as economies of scale and scope have led to a steady flow of bank mergers and acquisitions and a decline in the total number of U.S. banks.

Further, innovation has changed the provisions of financial services in several important ways. As banks digitize services and customers demand online and mobile access, physical branches have become less necessary. After a long period of growth in the number of outlets, banks closed more than 10,000 branches from 2009 to 2017.⁵² Today, internet banks without a physical presence are growing, and many online lenders make loans nationwide through partnerships with traditional banks. In such an environment, regulators need to assess whether judging CRA compliance solely based on activities near physical branches is becoming obsolete.

Earlier this year, the U.S. Treasury Department released a memorandum on the CRA that included proposals to reform the program. The department recommended that the prudential regulatory agencies rethink the definition of assessment areas to “account for the current range of alternative channels that exist for accepting deposits and providing services arising from the ongoing evolution of digital banking” and include areas where banks are serving LMI communities outside of areas where they have a physical presence.⁵³

This review is necessary. We recommend that the prudential regulatory agencies revisit how they define assessment areas to account for the ways lenders can serve communities in the modern era of banking. This review should include an evaluation of CRA credit given to investments that banks make in SBICs. Currently, banks can receive CRA credit for investments in SBICs, as long as the SBICs operate in the bank’s assessment area. But banks should receive CRA credit for investments in SBICs, regardless of the location of the SBIC, in order to encourage greater investment in these companies that provide needed capital to small businesses.

- **Regulators should ensure that their CRA regulations and supervisory practices encourage small business lending and investment to the same degree that they encourage other kinds of CRA lending and investments.**

When lenders extend credit to small enterprises and entrepreneurs in LMI neighborhoods, they not only provide opportunities for business owners, but also for the local residents those businesses employ. Well-underwritten loans are much-needed investments in LMI communities, and it is appropriate for government policy to encourage them.

Unfortunately, there is little research on how the 1995 changes to CRA regulations have impacted small business lending, in part due to the lack of available data on small business loan applications. One study found that the limited evidence available suggests that the CRA has had mixed effects on small business lending.⁵⁴ And while small business lending increased rapidly between 2003 and 2007, LMI communities and African-American neighborhoods did not benefit from the boom as much as other areas⁵⁵ and small business loan volume has recovered almost three times faster outside of LMI areas than within them since the financial crisis.⁵⁶

To help promote a dynamic economy in LMI areas, we recommend that the prudential regulatory agencies ensure that their regulations and supervisory practices encourage financial firms to lend to, and invest in, small businesses in LMI neighborhoods to the same degree that they encourage other kinds of CRA lending and investment. Once regulatory agencies have implemented the small business data-collection provisions of Dodd-Frank, regulators and banks should be able to use this data to help identify additional opportunities for providing credit to small businesses in LMI areas.

Reduce the Compliance Burden for Anti-Money Laundering Rules

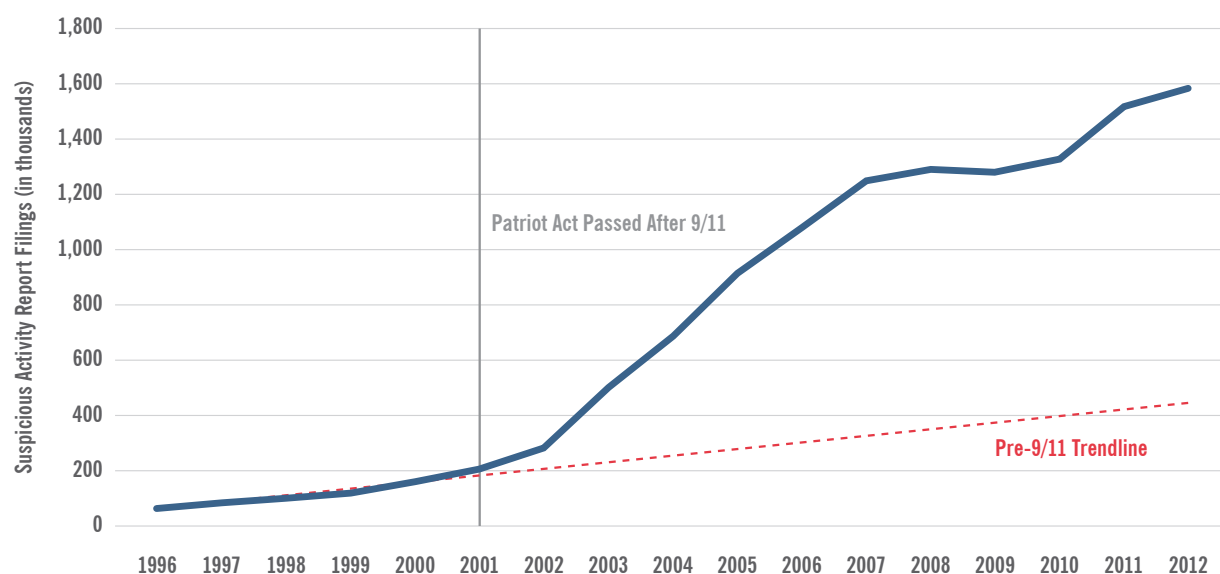
- **The U.S. Treasury Department should undertake a comprehensive review of anti-money laundering rules to assess the costs of implementation and recommend ways to reduce their negative impact on lending.**
- **The federal prudential bank regulatory agencies should issue joint guidance to encourage innovation that will better and more efficiently detect money laundering and terrorism financing.**

We heard from many lenders who said that anti-money laundering (AML) rules are among the most burdensome and costly from a compliance standpoint. While lenders continue to support the goals of the laws and the rules that make up the AML regime, that regime has evolved in a way that emphasizes compliance procedures with almost zero tolerance for error rather than outcomes.

Regulatory agencies designed the current AML regime to stop organized criminal activity, and it was later adapted to help with the war on drugs. Financial institutions effectively were deputized to report suspicious financial activity to law enforcement officials under the theory that banks are best equipped to detect when the financial system is used for illegal purposes. After the attacks of September 11, 2001, policymakers adapted AML rules again to prevent the financing of terrorism. One result of continuing to adapt AML rules to detect a wide variety of criminal activity is that the number of suspicious activity reports filed has grown faster than the trendline before 9/11 would have suggested (see Figure 2).⁵⁷

Figure 2: Post-9/11 Surge in Suspicious Activity Reports (SARs)

Number of Anti-Money Laundering SARs Filings



Source: Financial Crimes Enforcement Network, "Suspicious Activity Report Statistics (SAR Stats)." ⁵⁸

Under the current AML regime, no financial institution wants to find itself in a situation where it failed to report activity that turned out to be illegal, or especially that turned out to be the financing of a terrorist operation. Similarly, bank examiners do not want Congress to blame them for allowing a bank under their supervision to not report such activity. All the incentives lead banks to report any activity that is remotely suspicious. The result is that banks and law enforcement are drowning in paper without necessarily accomplishing their objectives in the most effective and efficient way. The system also encourages banks to drop customers deemed to pose some AML compliance risk. This process of “de-risking” negatively impacts firms such as check cashers and money transmitters.

A 2017 report from the Clearing House, developed with input from a variety of stakeholders, described the AML regime as “ill-suited for apprehending criminals and countering terrorism in the 21st century,” and it argues that the current system suffers from several flaws, including not prioritizing threats, barriers to sharing information, a regulatory system that discourages innovation, and inefficiency.⁵⁹

This dysfunction affects small businesses in at least two ways. First, the unnecessary compliance burden on banks allows them to devote fewer resources—time and money—to lending. Second, the AML compliance burden seems to fall most heavily on community banks, which have traditionally been most likely to lend to small businesses.

While a full assessment of AML rules is outside the scope of this task force’s work, we believe the current AML framework is negatively affecting small business lending. Therefore, we recommend that the U.S. Treasury Department conduct a comprehensive review of the AML framework and recommend ways to improve its effectiveness and efficiency.

In addition, we recommend that the prudential regulatory agencies issue joint guidance that will encourage and reward innovation that more effectively achieves the goals of the AML framework. Legislation in support of such innovation is pending in Congress.

Revise Qualified Mortgage and Ability-to-Repay Criteria to Help Qualified Small Business Borrowers More Easily Obtain Credit

- **The CFPB should adjust and clarify its qualified mortgage and ability-to-repay rules to better reflect the circumstances of small business borrowers who may not have a steady source of income.**

While bank loans are the most important source of external financing for small businesses, the most important sources of funds for these enterprises are more personal: money from friends and family, personal savings and credit cards, and home equity. Home equity is an especially important source of financing for new businesses without a substantial track record of performance.

Because of the pre-crisis proliferation of mortgages made to borrowers who could not afford to repay them, Dodd-Frank required the CFPB to establish standards to ensure that a mortgage lender fully assesses a consumer's ability to repay (ATR) a mortgage. The law and subsequent regulations established a class of qualified mortgage loans (QMs) that cannot have certain risky product features and that presumably comply with the ATR requirement.

The CFPB's ATR/QM rule establishes different categories of QMs. For example, if a loan does not exceed a certain annual percentage rate (APR) and meets the criteria that make it eligible for sale to either Fannie Mae or Freddie Mac, it qualifies as a QM and thus meets the ATR requirement. If a loan is not eligible for purchase by Fannie or Freddie, a loan can still be a QM if it meets several additional standards. For example, the borrower must have a debt-to-income ratio of 43 percent or less. The QM rule also sets forth qualification, documentation, and verification standards for determining a borrower's monthly debt and income.

However, the debt and income verification standards in the CFPB mortgage lending rule has made it difficult for many small business owners to obtain credit when they use their home as collateral. The standards do not always reflect modern employment and income trends, documentation standards, or technological norms for documenting and verifying debt and income. Sole proprietors and small business owners who do not have a steady income flow are especially harmed by the ATR underwriting standards. These applicants are often not able to provide the sufficient income documentation needed to qualify for a loan.

Separately, if a consumer is employed by a family-owned business, the consumer must provide evidence that they are not an owner of the business. The CFPB rule does not provide a definition of family-owned business, and it is unclear whether it includes extended family members. A clarification of this definition alone could make lending to small businesses more efficient, both for borrowers and lenders.

Therefore, we recommend that the CFPB review the underwriting standards associated with the QM rule to better address the financing needs of small business owners who may rely on a home as collateral for starting or continuing a small business.

Financial regulation can have a substantial effect on the extension of credit to small businesses and entrepreneurs. Implementing common-sense reforms to streamline and adjust rules to better account for the specific circumstances faced by small business owners would make the financial system work better without compromising the improvements made in the Dodd-Frank Act and other post-crisis reforms.

Pay Small Businesses on Time

- **The SBA should build off the success of the QuickPay program to reduce the amount of time it takes federal small business contractors to get paid.**

According to a 2017 report by *Sage*, more than 30 percent of small- and medium-sized businesses are expecting to or are experiencing adverse effects from late payments.⁶⁰ The report further indicates that 30 percent of firms dealing with late payments don't pursue payment out of fear of harming their client relationships. Late payments are a major source of cash flow problems for small businesses, and they impact staff payroll and investments and increase small businesses' demand for financing to stay afloat.

In 2011, the SBA launched the QuickPay program to direct federal agencies to pay their small business contractors in 15 days.⁶¹ A review found that the program had a positive effect on employment, especially in high-unemployment regions.⁶² The SBA should build off the success of the QuickPay program to ensure that the federal government continues to pay small business owners in a timely manner.

Small Business Loan Disclosures

- **While the Co-chairs have a range of opinions about the institutions to which this should apply, Congress should direct the Federal Trade Commission (FTC) to develop a simple disclosure form for loans and advances to small businesses.**
- **The federal banking agencies and the Federal Trade Commission should jointly assess whether small business borrowers find it difficult to understand the terms of the loan documents.**

A well-functioning small business lending market requires borrowers who have the knowledge, resources, and expertise to both understand their credit options and to select the loans that are best for their businesses. Transparency from both lenders and borrowers is essential. It is also critical to sustain the incentives for lenders to make small business loans and to avoid adding regulatory compliance requirements that do not provide significant benefits. While we all agree that finding this balance is vital to borrowers, lenders, and the overall economy, the task force has not reached a complete consensus on the trade-offs involved in additional transparency obligations.

When consumers shop for a mortgage, a credit card, or a personal loan, certain regulatory requirements help them appreciate the cost and repayment responsibilities that come with the loan. For example, to help ensure that consumers understand loan terms, Congress enacted the Truth in Lending Act (TILA) in 1968 to establish national disclosure rules for consumer borrowing. Historically, small business loans have not been subject to TILA and other disclosure requirements because entrepreneurs and small business owners are considered more sophisticated customers, more likely to have relationships with their banks and to better understand the terms and risks associated with loans.

However, small business owners vary a great deal in their financial expertise. Most small businesses have no employees, and the loans they take out are often similar to consumer loans. Many small business loans are backed by personal collateral (such as a home). Just this year, the Federal Reserve Board conducted a focus group of small business owners and found that participants were unable to accurately compare the costs and features of online products.⁶³ There can also be confusion around some forms of small business credit, called merchant cash advances. These products are not classified as loans and, as such, are not expressed in terms of an APR, making it challenging to compare with other types of credit products.

While in general small business owners should have a greater understanding of financial risks and burdens than individual consumers, in practice the sophistication of small business borrowers varies widely. And although most bank and nonbank lenders seek to make the elements of a loan clear to the borrower, there are instances where opaque loan documentation leads to poor outcomes for both consumers and lenders alike.

The entrance of nonbank lenders has raised new concerns about a lack of clarity about small business loan terms. In response to these concerns, several nonbank lenders have developed self-regulatory measures such as the [SMART Box](#), which is designed to give small business owners basic information on loan terms.⁶⁴ The SMART Box is a model disclosure box that was designed in 2016 by three major online lenders. It provides easy-to-understand statistics, such as APR and average monthly payments, in one place. Unfortunately, while most online lenders provide useful disclosures, some do not provide clear information that is consistent with the goals of the Small Business Borrowers' Bill of Rights or that use the SMART Box or a similar disclosure.

Requiring a SMART Box like disclosure would ensure that small business borrowers receive basic information about loan terms and conditions when obtaining funds from nonbanks lenders, whether they are offering traditional loans or providing cash advances based upon receivables.⁶⁵

In the case of bank loans to small businesses, some task force members also believe that a new, federal disclosure regime is necessary. Other Task Force members believe that the vast majority of banks provide sufficient information about loan products to their small business loan customers and that additional disclosure requirements would unnecessarily make lending more expensive. Appendix A lists a more detailed elaboration of our individual views on this issue.

Recognizing that effective congressional action means reconciling these different views, we recommend that the federal banking agencies and the FTC jointly undertake an assessment to determine if small business borrowers find it difficult to appreciate the terms of the loan documents. In conducting the assessment, the agencies should seek input from state officials who have supervisory authority over small business lending. This evaluation will provide the insights Congress will require to determine whether it needs to make other proactive efforts to ensure that small business owners receive sufficient information when obtaining a loan.

- **Congress should amend the Fair Debt Collection Practices Act to apply to debts incurred by small businesses with less than \$500,000 in annual revenue.**

Debt collectors should be able to collect debt from borrowers using legitimate means. This can reduce the cost of credit by allowing lenders to recover more money from delinquent borrowers. However, certain debt collection practices can be abusive and regulations should counter them.

The Fair Debt Collection Practices Act (FDCPA) limits certain debt collection practices (mainly for loans used for personal, family, or household purposes), such as the time and place debt collectors can contact someone, and prohibits certain harassing behavior, such as using abusive or profane language.

The FDCPA does not cover business debt, which can leave many small businesses vulnerable. The lack of protection against certain debt collection practices can cause small business owners to spend considerable time dealing with debt collection practices average consumers don't have to face.

Anecdotally we heard evidence suggesting small businesses would benefit from this protection. For instance, we learned about a small business owner whom a debt collector called three times a day for debt collection based on a provision slipped into the loan contract that required small business owner to lease and pay an exorbitant amount for a coffeemaker they could not afford. This small business owner had to spend hours on the phone talking to debt collectors, rather than managing their business.

Congress should amend the FDCPA to cover loans to small businesses with less than \$500,000 in revenue. These small businesses have fewer resources and less time to deal with the debt collection process and would benefit from the protections provided by the FDCPA.

Section III. Making U.S. Capital Markets Work Better for Small Businesses

U.S. capital markets are widely acknowledged to be the deepest and broadest in the world, providing nearly four-fifths of the debt financing for U.S. businesses. Businesses rely on capital markets to issue debt securities such as corporate bonds and commercial paper to make public stock offerings and raise capital.⁶⁶ In addition, municipalities rely on capital markets to raise bonds to fund infrastructure, schools, and other community projects, while consumers benefit from financial markets and securitization for financing their mortgages, credit cards, and auto loans.

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Despite the depth and breadth of U.S. capital markets, they have little direct impact on the financing of Main Street small businesses and proprietorships.

Despite the depth and breadth of U.S. capital markets, they have little direct impact on the financing of Main Street small businesses and proprietorships. While many young, high-growth and some larger small businesses can rely on initial public offerings (IPOs), venture capital, and other market mechanisms, equity funding remains challenging for most other small businesses. In 2017, the U.S. Treasury Department reported: “For a small business seeking to raise capital, identifying and locating potential investors can be difficult. It becomes even more challenging if the amount sought (e.g., less than \$5 million) is below a level that would attract venture capital or a registered broker-dealer, but beyond the levels that can be provided by friends and family and personal financing.”⁶⁷

Several key areas of capital market financing worth exploring are securitization, venture capital, public offerings, and equity crowdfunding.

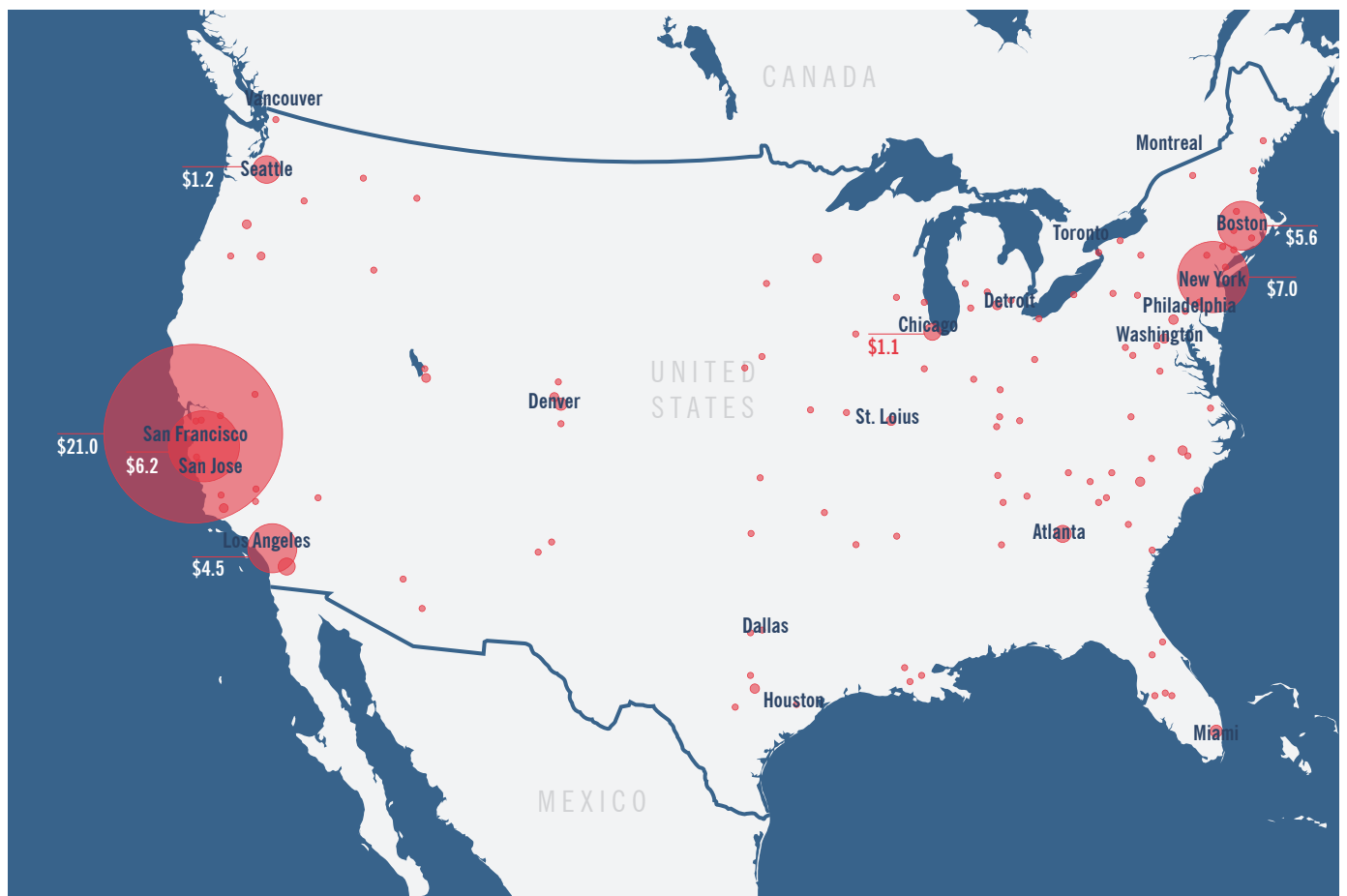
Securitization is the process of packaging individual loans and debt instruments to create a new security that better matches investor risk/return preferences. Securitization allows lenders to off-load risk from their balance sheets onto investors in secondary markets, leaving lenders able to make more loans. Securitization and a well-functioning secondary market could make capital more accessible and affordable to small businesses by allowing institutional investors, hedge funds, and others to directly invest in small business loans. Securitization works well for standardized loans such as mortgages, where it is easy for investors to understand what they are getting, but it has been difficult for small business loans because of the variety of characteristics of small businesses.

Several financial technology (fintech) lenders have been securitizing small business loans from their portfolio.^{68,69} The fintech companies’ ability to leverage technology to collect and standardize small business loan data provides more information for investors, so they can make better investment decisions. However, it is too soon to tell how effective this approach will be in providing new sources of capital for small businesses, since these securitizations have not gone through a full business cycle. (Investors don’t know how well they will perform in a recession.) Therefore, policymakers should take a wait-and-see approach on the long-term viability of small business loan securitization.

Venture capital is another source of funding for small businesses, but it tends to be concentrated in a handful of urban parts of the country (see Figure 3). In fact, nearly two-thirds of all venture capital investment in the United States goes to just three metro areas: the California Bay Area, New York, and Boston.⁷⁰ Some of this concentration is understandable; centers of innovation tend to attract other innovators in a positive feedback loop. However, some of this concentration may be driven not only by the fact that it is easier and less costly to identify venture targets in dense urban areas because of existing networks of innovators and investors, but also because it simply takes more time and resources to travel to locales that have fewer potential investment targets. The result is that many deserving entrepreneurs outside these hubs find themselves shut out of access to venture capital. As technology continues to make physical distance less of a factor in human interactions, it may become easier for venture capital investors to find opportunities in diverse parts of the country. In the interim, remote entrepreneurs should explore other sources of equity capital.

Figure 3: Venture Capital is Concentrated in a Few Regions

2017 Venture Capital Investment (\$ billions)



Source: National Venture Capital Association.⁷¹

Public equity markets can also help some of the larger small businesses. Policymakers designed the Jumpstart Our Business Startups (JOBS) Act of 2012 to encourage more funding for small- and medium-sized businesses. The act provides exemptions from some compliance requirements for accessing public markets, making it easier for certain high-growth companies to issue IPOs. It is too early to fully assess how effective the JOBS Act has been in achieving the goal of making public markets more accessible, but there are some mixed indicators. Emerging-growth companies—a more lightly regulated category created by the JOBS Act for issuer companies with less than \$1 billion in total gross annual revenue—now make up most of the IPO market,⁷² and IPO activity increased significantly following implementation of new rules in 2015.⁷³ However, some research indicates that the costs of going public have not actually decreased, and IPOs for emerging-growth companies have been underpriced because investors view them as higher-risk since these companies do not have to disclose as much information pre-IPO.^{74,75}

Crowdfunding

Crowdfunding is a mechanism for raising money from a large group of people through an online platform. There are many variations of crowdfunding, including donation-based, reward-based, and equity-based. Donation-based crowdfunding is probably the most well-known, with platforms like GoFundMe that raise resources through donations. Reward-based crowdfunding exchanges a product or service in return for funding. For example, one successful reward-based crowdfunding campaign was an Atlanta-based board-game business which offered advanced delivery of the game in exchange for funding; it raised more than \$3.5 million.⁷⁶ Finally, small businesses use equity-based crowdfunding to raise resources from investors. The investor receives shares of the business in exchange for funds. Crowdfunding is exciting because of its potential to break down geographic barriers and help many underserved communities access capital.

Equity crowdfunding is another source of capital for small businesses. Equity crowdfunding is the process by which a private small business raises money by using an online platform to sell shares in its firm. The JOBS Act required the Securities and Exchange Commission (SEC) to promulgate a rule allowing small businesses to raise up to \$1 million during any 12-month period through equity crowdfunding campaigns without having to register the securities with the SEC.⁷⁷ The goal was to create additional opportunities for start-ups and other small enterprises to raise funds using the internet. In 2012, when the Act passed, sites such as Kickstarter were flourishing. In 2015, the SEC finalized a new investment crowdfunding rule known as Regulation CF.

Prior to the JOBS Act, private companies could only raise equity capital from accredited investors, who are individuals with high incomes, net worth, or professional experience with securities, as well as certain organizations and trusts. Regulation CF opened opportunities to invest in private companies to the public. The regulation limits how much such nonaccredited investors can invest in crowdfunding offerings during a 12-month period to a percentage of their income or net worth, with a current cap of \$107,000 regardless of income or net worth.

So far, equity crowdfunding in the United States has been limited and is growing more slowly than in Europe. However, this can be a promising source of equity for small businesses and policymakers should build on it.

Recommendations

Improve Equity Crowdfunding Regulations

- **The Securities and Exchange Commission (SEC) should review Regulation CF to identify ways to make it more effectively support crowdfunding campaigns, assess the costs and benefits of collecting more data, and analyze disparities in crowdfunding among different demographic groups.**

Expanding equity crowdfunding as a source of funding can help small businesses raise capital, but so far that strategy has seen limited uptake. The SBA's Office of Advocacy's analysis of the rule's first year⁷⁸ found that only 326 small businesses attempted to raise capital through equity crowdfunding, and just \$30 million was raised.⁷⁹ While that money was surely important to the firms that raised it, the total barely qualifies as a footnote in the overall equity funding market. In contrast, crowdfunding has grown rapidly in the United Kingdom and Europe;⁸⁰ equity crowdfunding in the United Kingdom reached 272 million pounds in 2016.⁸¹

The Office of Advocacy's report also found that men-owned firms initiated most of the equity crowdfunding campaigns, despite previous research showing that female entrepreneurs have been both well represented and successful in rewards-based crowdfunding. (Rewards-based crowdfunding raises money for a start-up by compensating investors with the start-up's products and services instead of its equity.) Further, the assessment concluded that there was "less crowdfunding activity among businesses located in states and metropolitan areas that are not already considered technology or finance hubs." In addition, the report noted that a lack of data made it "difficult to measure crowdfunding participation among minority- and veteran-owned businesses, or among businesses in specific industries."⁸²

To better understand disparities in financing and trends for minorities and veterans, the SEC's Division of Economics and Risk Analysis should review the growth and performance of equity crowdfunding under Regulation CF. The review should analyze and assess:

1. The types of businesses that have attempted to raise funding under Regulation CF and the demographic characteristics of their owners;
2. The types of organizations and the demographic characteristics of investors who have invested in equity crowdfunding;
3. Significant barriers to raising funding or investing in crowdfunding offerings;
4. The quality of data available on equity crowdfunding and the benefits and costs of collecting additional data;
5. Ways to improve Regulation CF to better support equity crowdfunding opportunities and extend benefits to underserved demographic groups;
6. Any significant gaps in regulation; and
7. Any instances of deception or fraud.

Once the review is complete, the SEC should consider adjustments to Regulation CF to improve equity crowdfunding, while protecting investors. If necessary, the SEC should recommend statutory changes for Congress to make.

- **Congress should give the SEC the authority to raise the cap on how much wealthier individuals can invest in crowdfunding campaigns.**

As noted above, Regulation CF caps the amount individuals can invest in equity crowdfunding in a 12-month period based on their income and net worth. In addition, Congress placed an overall cap on investments regardless of income or net worth, currently at \$107,000 but adjusted for inflation at least once every five years. The SEC interpreted the intent of Congress in establishing this cap to encourage small investors by making crowdfunding transactions “equally available to all types of investors.”⁸³ This led the SEC to decline to raise the cap, except to adjust for inflation.

A 2017 U.S. Treasury Department report found that “[t]he current rules unnecessarily limit investors who have a high net worth relative to annual income, or vice versa,” from making crowdfunding investments, and it recommended increasing those limits.⁸⁴ The growth of crowdfunding in Europe and other parts of the world appears to support the assessment that the caps have limited the utility of this mechanism to support small businesses.⁸⁵

Congress should provide the SEC with the authority to raise the caps on investment amounts in crowdfunding campaigns by wealthier individuals. Increasing the caps will make crowdfunding campaigns more attractive to investors and attract more capital to crowdfunding firms. When deciding whether to increase the cap, the SEC should assess how best to balance assisting organizations that initiate crowdfunding campaigns and ensuring that small investors can be well-represented in these campaigns.

Improve Access to Training and Mentorship

- **The SBA should work with small business mentoring and training partners to identify gaps in these types of services to small businesses and take steps to improve access, including ensuring the agency and its partners are maximizing technology and e-learning strategies.**

Over the course of our deliberations and outreach, small business owners told the task force that some of the SBA programs designed to mentor entrepreneurs and small businesses were useful but could be improved to better match their schedules and specific needs. The SBA should work with its resource partners—small business development companies, the Service Corps of Retired Executives, women's business centers, and veteran-owned business centers—and other effective private training and mentorship organizations and programs to identify gaps and improve access to training. The SBA should ensure the agency and its partners are maximizing technology and e-learning strategies to meet these goals.

- **SBA district offices should further partner with regional business accelerators and incubators to improve access to business resources and venture capital funding.**

Business accelerators provide start-ups with education, mentorship, and access to financing over a fixed period in exchange for an equity stake in the company. The goal is to accelerate the life cycle of the small businesses.⁸⁶ The accelerator program ends with a demo-day, when the entrepreneurs present their businesses to the start-up community and potential investors.⁸⁷ Incubators provide many of the same services but charge a fee for the services. The activities that accelerators and incubators engage in benefit not only the small businesses themselves, but they create spill-over effects as the areas where the incubators and accelerators are active attract more venture capital.⁸⁸ In fact, one study found an 85.6 percent increase in the number of distinct investors following the opening of an accelerator.⁸⁹

The SBA has worked with incubators and accelerators through programs such as the SBA Growth Accelerator Fund Competition.⁹⁰ The SBA should expand this partnership. SBA district offices, accelerators, and incubators all provide mentorship, business resources, and greater access to external financing for small and growing businesses. Improved cooperation between the SBA's 74 district offices⁹¹ and the many incubators and accelerators across the country could provide even greater value to entrepreneurs and attract more investment.



Section IV. Promoting Innovation and Integrating Technology

Federal Reserve Board Chairman Paul Volcker once famously said, “The ATM has been the only useful innovation in banking for the past 20 years.”⁹² Even if that were true in 2009, it is not true today. New fintech firms have created and delivered useful new products and services in new ways and are forcing traditional mechanisms to become more innovative. In other words, fintech is transforming the financial services industry.

Fintech companies, many of which are start-ups themselves, have made advancements across a range of financial interactions, including payments, automated advice, mobile technology, virtual currencies, and, of course, lending. Online lenders such as OnDeck, Kabbage, and Lending Club not only created an online lending process, but they also gave potential borrowers a faster, more user-friendly loan application experience. They have moved beyond FICO credit scores in making credit decisions by using nontraditional forms of borrower data—such as bill payment history, educational background, and property ownership.

The staying power and long-term success of the early fintech companies is still unclear. While borrowers report a quicker and easier loan application process with online lenders, they prefer the post-decision experience with traditional banks.⁹³ Lending also is an inherently risky business, and some innovations may not be viable in periods of economic stress. In sum, fintech firms are still in an early phase of development, and it remains to be seen which technologies or approaches will prove successful.

Future fintech innovations may be even more transformative. Many financial service providers are experimenting with artificial intelligence and machine learning to offer financial advice or to complete basic tasks for their customers. These tools could evolve to provide real-time, actionable intelligence to help small business owners evaluate their financial conditions and options. This could offer a variety of benefits to small business owners, ranging from real-time payments to improvements in credit underwriting and access to more and better data that reduce both the risk of lending and borrowing costs. Future innovations also should allow greater customization of financial products to fit the specific needs and circumstances of individual businesses.

Yet, innovation is not without its risks. New technology is allowing the collection and analysis of data at an unprecedented level. This data can provide powerful insights and intelligence, but data collection also raises privacy and security concerns. Data security and privacy are major issues as hackers have breached banks, large retailers, and even the U.S. government and stolen personal and financial data on millions of Americans.

Financial regulators and the financial services industry will need to find the right balance between promoting beneficial fintech innovation while mitigating potential problems.

Recommendations

Innovation Greenhouses

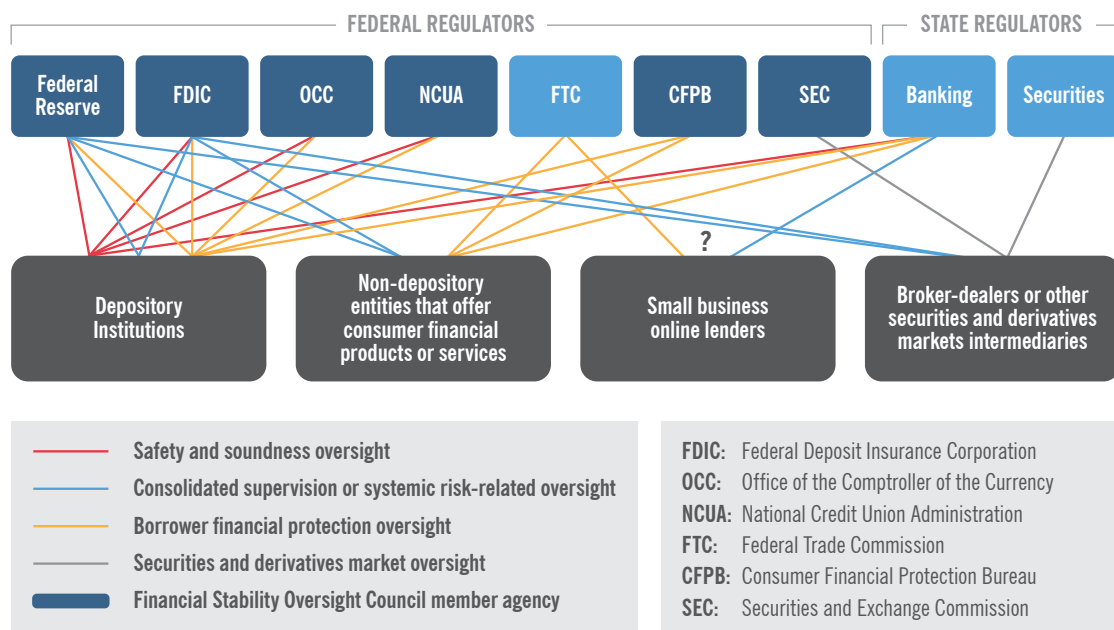
- **Federal and state financial regulatory agencies should establish technology and innovation offices. Each office should create a “greenhouse” to work in partnership with the private sector to use technology to promote responsible financial innovation with prudent risk management.**

Financial regulatory agencies should establish offices focused on the use of technology and the promotion of what the OCC calls “responsible innovation”—that is, innovation that meets the needs of consumers, businesses, and communities in a way that prudently manages risk.⁹⁴ Several financial regulatory agencies have taken this step. In 2012, the CFPB launched Project Catalyst to foster consumer-friendly innovation. In 2016, the OCC created its Office of Innovation and a framework for responsible innovation. The Commodity Futures Trading Commission (CFTC) established LabCFTC to promote “responsible FinTech innovation and fair competition.”⁹⁵ Each of these technology offices is focuses on how best to adapt to changes brought about by fintech.

We recommend that each federal agency that is a member of the FSOC establish its own office of technology and innovation to monitor trends and innovations, assess their likely impacts, and, where appropriate, help develop regulatory responses to facilitate responsible innovation. Because fintech often affects financial firms in similar ways yet oversight of these firms is divided among different agencies (see Figure 4), regulators should require these offices to coordinate with each other. The FSOC agencies can and should improve interagency efforts to understand and respond to innovations. The FFIEC, a body designed to help coordinate financial regulatory agencies, should assist in this coordination among the offices of innovation. To further improve coordination, the FFIEC should establish an advisory council with experts on innovation, including venture capital firms focused on fintech, incubators, accelerators, and crowdfunding companies to provide feedback to technology and innovation offices.

Figure 4: Fragmented Regulatory System for Small Business Lending

Regulatory Agencies, Their Mission, and Regulated Entities



Source: Karen Gordon Mills and Brayden McCarthy, “The State of Small Business Lending: Innovation and Technology and the Implications for Regulation”⁹⁶; U.S. Government Accountability Office, *Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*.⁹⁷

State financial regulators also should consider creating offices of technology and innovation. The CSBS has taken a step in this direction with its Vision 2020 program, which aims to modernize state nonbank financial regulation by supporting innovation, enabling fintech companies to operate at a national scale, strengthening the financial system, and protecting consumers.⁹⁸ Vision 2020 includes a goal of an integrated 50-state licensing and supervisory system. To the extent possible, states should work with the private sector and with public universities, many of which have successful track records fostering innovation in other fields. States also should work with business and community leaders and academics within the state to share knowledge and expertise.

A regulatory “sandbox” has become a popular tool for regulators around the world to promote responsible innovation. A sandbox is a program that allows innovative firms to test out new products and services in a limited market environment with safeguards in place to protect customers. Firms that participate in a sandbox work with agency personnel who provide regulatory guidance and feedback. Regulators also may waive or modify the application of some rules on a temporary basis while a product is tested, or they may issue no-action letters that state that the agency will not take enforcement action against certain activities that are tested within the sandbox.

Under Project Innovate, the United Kingdom’s Financial Conduct Authority (FCA) created perhaps the most well-known sandbox, which has reduced the time and cost of getting innovations to market and facilitated greater access to finance for participating firms.⁹⁹ Earlier this year, Arizona became the first state to create its own fintech sandbox, although the state’s Office of the Attorney General oversees it rather than its financial regulatory agency.¹⁰⁰

To augment the establishment of offices of technology and innovation at each financial regulatory agency, each office should create an innovation greenhouse¹⁰¹ to promote responsible innovation. Each greenhouse should adopt a few important practices:

1. Require the firms that apply to participate in the greenhouse demonstrate the requisite product viability, business plan, leadership, risk governance, and financing to succeed, and ensure that the products or services the firms want to test are likely to benefit consumers and/or business customers.
2. Put appropriate safeguards in place to avoid or address any unintended consequences that may arise from testing these innovations in a market setting.
3. Use regulatory forbearance, potentially including waivers and no-action letters, to allow firms to test innovations under supervision.
4. Design an iterative process to provide regular feedback to participating firms and assess how to adjust existing regulation to adapt to changes in market dynamics caused by the innovations under testing.
5. Establish a concrete time line for testing the innovation.

Streamline and Eliminate Gaps in the Regulation of Nonbank Fintech Companies

- **Congress should amend the National Bank Act to authorize the Office of the Comptroller of Currency (OCC) to issue a federal charter for nonbank financial companies.**
- **States should continue to work together through the Conference of State Bank Supervisors to harmonize requirements, supervision, and coordination for nonbanks operating in multiple states.**

In 2016, the OCC took several important steps to promote innovation and to assert its role in the oversight of nonbank fintech companies. These steps included: developing a responsible innovation framework,¹⁰² establishing an Office of Innovation, providing training for OCC staff, and implementing new policies to better provide technical assistance to fintech companies to improve collaboration with other agencies.¹⁰³ Later that same year, the OCC created controversy when it announced its plan to authorize a limited-purpose federal charter for nonbank fintech firms. The OCC's plan relied on its authority to charter special-purpose national banks, which is an authority that had long existed but never been used in the context of nonbank fintech firms.¹⁰⁴ Under the plan, to qualify for a federal charter, fintech companies need to provide the OCC with a business plan, an appropriate governance structure, a compliance risk-management plan, a recovery and exit plan in the event of failure, and a strategy to serve low- and moderate-income neighborhoods and unserved areas. The OCC also stated that it would require these firms to meet capital and liquidity requirements commensurate with the risk and complexity of the fintech firm's products and services.¹⁰⁵

A few months after the OCC announced its plans for a federal charter, the CSBS sued to block the action. The CSBS argued that the OCC did not have the statutory authority to charter a limited-purpose national bank that did not accept FDIC-insured deposits and that the OCC had violated the Administrative Procedure Act by not subjecting the charter proposal to public notice and comment. The CSBS also noted that a federal charter would allow fintech firms the ability to avoid state laws.¹⁰⁶ The New York Department of Financial Services (DFS) filed a separate, similar lawsuit. In 2017 and 2018, courts dismissed both cases on procedural grounds. The courts found that the CSBS and the DFS lacked standing because the OCC had not yet issued the charter.^{107,108} The OCC was expected to release a report in July outlining how it intends to proceed, if at all, with a fintech charter. If the OCC does move forward with a charter, the lack of certainty about its legal authority to issue the charter will remain in question and likely spawn additional lawsuits.

At the same time, states have acknowledged that the patchwork of different state laws and regulations creates unnecessary burdens for fintech companies operating in multiple jurisdictions.¹⁰⁹ This problem is especially pronounced in the fintech space since these firms often operate on the internet rather than in brick-and-mortar branches, and thus effectively operate in every state. Extra compliance requirements raise the cost of doing business and can increase the cost of credit to small businesses and other borrowers.

The United States has long operated under a dual banking system with both state and federal charters to allow banks to select the charter that best fits their needs and lets them best serve their customers. A bank operating in multiple states may be better served by a federal charter that applies consistent rules on safety and soundness, licensing, marketing, governance, and other activities, while a bank operating in one or a few states may prefer a state charter. The establishment of new limited-purpose federal charter for fintech companies would be consistent with this framework. It would allow firms to select between state or federal regulation.

Even if the courts uphold the OCC's authority to establish a nonbank charter, that authority was not designed with modern fintech companies and other nonbanks in mind. Rather than the OCC stretching existing authorities to address current gaps in regulation, Congress should explicitly authorize the OCC to issue a federal nonbank charter that can engage in lending and payments activities, other than the acceptance of FDIC-insured deposits.

This charter should adhere to several principles:

1. *Regulate like activities in like ways.* If a nonbank offers a product or service that is like one offered by a bank, it should be regulated in a like way. Similarly, regulation should account for the differences between banks and nonbanks (for example, banks accept insured deposits and nonbank fintech firms do not). Such an approach would level the playing field between banks and nonbanks, promote competitiveness, and reduce opportunities for regulatory arbitrage that could generate additional risk in the financial system.

To ensure that borrowers have all the information they need to understand their credit options, firms that opt for a federal charter should be subject to minimum standards for clear disclosure of all terms and conditions of products and services.

2. *Provide for preemption of state laws.* One of the primary attractions of opting for a federal charter is the ability to operate in multiple states under a uniform legal framework. The National Bank Act already includes preemption authority for nationally chartered banks, and federally chartered limited-purpose fintech banks should have the same authority.
3. *Build in flexibility.* The pace of innovation in fintech is increasing, and it is impossible to precisely predict which changes are on the horizon, much less how their adoption will alter the landscape of financial services. For this reason, a federal fintech charter cannot be designed simply to address technologies and issues that are already visible. It must be flexible enough to enable federally chartered fintech firms to engage in new products and services as they emerge. In other words, the OCC should be given the authority to approach fintech regulation as an evolving mandate and should update its rules and guidance to reflect changes in the financial products and services market.
4. *Tolerate failure.* Although not something that should necessarily be written into a charter, the OCC will need to adapt its culture to oversee nonbanks differently than it oversees banks. Bank prudential supervisors are appropriately focused on ensuring the safety and soundness of banks within their jurisdiction. If a bank does not use sound risk management practices, it puts the FDIC's Deposit Insurance Fund, and potentially taxpayer dollars, at risk and may even threaten the stability of the financial system. The failure of a fintech firm, however, is highly unlikely to affect financial stability. Nonbank financial firms do not accept insured deposits, nor do they operate with substantial leverage that can threaten overall financial stability.

Innovation necessarily involves the risk of failure and the fintech world is no different than most other innovative industries. As Aaron Klein from the Brookings Institution and Brian Knight from the Mercatus Center have noted, "Technology embraces risk taking—innovation is common and failure is not a sign of malfeasance. . . . To the extent these companies are regulated, the regulators will need to understand that failure is a necessary part of a healthy economy."¹¹⁰ To best regulate fintech companies and promote innovation, the OCC will need to foster a fintech supervisory culture that is more tolerant of failure than its bank supervisory culture.

In addition to the OCC creating a federal charter, states should continue to work through the CSBS to create greater uniformity and coordination in state fintech regulation. Our goal is to strengthen, not diminish, the dual banking system. Continued innovation and cooperation among state regulators will ensure this. Through its Vision 2020 initiative, the CSBS is helping to train state regulators, harmonize multi-state supervision, streamline licensing requirements, and more.¹¹¹ While it may be that most fintech firms will continue to opt for state charters, having a congressionally authorized federal nonbank charter in place to mirror the dual banking system would be an appropriate complement to state regulatory efforts.

Coordinate Third-Party Guidance

- **Federal bank regulatory agencies working through the Federal Financial Institutions Examination Council (FFIEC) should develop joint guidance for third-party vendor management.**
- **The FFIEC should develop a common standard to certify when vendors have complied with third-party guidelines.**

As fintech start-ups have designed innovations that change the dynamics of financial services, traditional banks have responded. Banks have pursued three main routes to incorporate fintech advances into their business models. First, some have purchased fintech start-ups in order to directly acquire their technology. Second, others have decided to build their own versions of innovations to better fit their unique business models. Finally, some banks have entered into partnerships with fintech companies as a relatively low-risk way to augment their capabilities while also allowing each partner to focus on its core competencies. Many banks have pursued more than one of these approaches.

If a bank chooses to partner with a fintech firm, the bank must contend with regulatory guidance regarding how to manage risk with third-party vendor relationships. Vendor relationships can generate substantial risk for banks. For example, the failure of a utility provider could crash a bank's operational systems or interrupt online service offerings, while a hacked IT vendor could result in the theft of the private records of bank customers. Financial regulatory agencies developed guidance to help banks assess, plan for, and respond to these risks.

Regulators should update third-party vendor guidance to reflect these new fintech partnerships.

A first step should be improving coordination among federal bank regulators. Currently, each agency has adopted separate guidance. Earlier this year, senior officials from the Fed, the FDIC, and the OCC said they would work to better understand bank-fintech partnerships and educate their staff on how to interpret guidance. The officials also signaled better coordination among themselves, with one Fed official saying, "If you touch one of us, . . . there's a bigger likelihood that you will be having a meeting with some or all of us."¹¹² These are positive developments.

The three bank regulatory agencies—the Federal Reserve, the FDIC, and the OCC—should work through the FFIEC to develop joint guidance for third-party vendor management. The FFIEC was designed for such joint initiatives. Joint guidance does not mean that regulators should treat each type of financial firm the same, but rather that guidance should be consistent and applied to similar products and activities in similar ways. Joint guidance should reduce the costs of compliance for financial firms and fintech firms, and it will reduce any confusion that may result from following disparate guidance from multiple regulators.

Also, streamlining the process for entering into third-party vendor partnerships would help facilitate innovation. Banks have expressed concern that the current guidance requires banks to devote significant resources and several months or more to review vendors, which, while understandable, makes partnerships less appealing, especially with start-up fintech firms.

Finally, the FFIEC should work with member agencies to develop a certification process for vendors. This process would vet vendors and speed up the process by helping vendors become better informed and compliant with third-party vendor guidelines. Such a process would be especially beneficial to new and small vendors that are often inexperienced in navigating guidance and regulatory expectations. After an agency vets and certifies a vendor as a qualified partner for a bank, the vendor could enter into partnerships with additional financial firms. The FFIEC should design the certification process to avoid inadvertently favoring larger and more established vendors, which could create unintentional barriers to entry for new and smaller vendors.

Taken together, these recommendations will encourage innovations that augment the ability of small businesses to succeed in a variety of ways, while at the same time addressing gaps and inconsistencies in the regulation of fintech.

Appendix A. Elaboration of Co-Chair Views on Small Business Lending Disclosures

Paul Greig:

Transparency for small businesses is important in a well-functioning economy. However, in my many years working in the banking industry, I have yet to hear of or see evidence indicating that transparency in small business lending is a significant problem. Absent an explicit determination that there is a problem requiring a regulatory response, I believe the costs of mandating new disclosure requirements for banks would exceed the benefits.

I have reviewed a variety of small business loan documents from several bank lenders and found the language to be clear and unambiguous. The loan documents clearly and prominently identify relevant terms and highlight the most important information, including the interest rate and repayment terms. These terms should be simple for small business owners to understand, given their business acumen and resources. Setting up a business often requires dealing with government permitting and licensing requirements, activities that require accountants and attorneys who can assist with borrowing decisions.

One can more reasonably argue in favor of disclosure rules for small business owners using home equity for funding, since consumer home loans are more heavily regulated and require numerous fees. However, consumer disclosure requirements already apply to these loans.

New disclosure requirements would force banks to add additional system support and staff to ensure compliance. They would also discourage lenders from tailoring loans to fit the specific needs of small businesses, since customizing a loan can result in accidental errors on the disclosure form and costly litigation. Compliance costs could be significant, and many would be passed on to small businesses.

Data-driven decision-making is essential and often lacking in public policy. I believe everyone should be open to changing their views based on new evidence. However, absent such evidence, the cost of creating mandated disclosure requirements for bank small business loans would likely exceed the benefits, and small businesses would face higher costs and have fewer products to choose from.

Karen G. Mills:

It is important that small business loan disclosures provide clear and forthright information about the costs, payment policies, and any other terms to small business owners seeking loans. Surveys have shown that deciphering loan agreements can be confusing,¹¹³ and small business owners deserve the same kinds of protections currently provided to consumers. It should be in the interest of all financial institutions to include this kind of information, including banks and nonbanks, as customers appreciate transparency. In addition, such clarity will ensure that small businesses achieve the right customer-product fit when making a loan decision—that is, they take on a loan that is the right amount, the right cost, and the right terms, and are therefore more likely to achieve successful repayment.

Currently, the kinds of disclosures required for consumer, student, and mortgage loans do not apply to small business loans. The lack of a universal metric for disclosure in lending prevents small business borrowers from shopping and comparing loan offers. Therefore, borrowers often fail to realize that they are paying higher prices than they need to. These disclosures are essential not only because they will dramatically decrease the time small businesses spend looking for viable loans, but also because they can guard small businesses from predatory lenders and other bad actors.

For all banks, large and small, disclosure requirements already exist in formats that can be used for small business loans. It would not be overly burdensome for bank lenders to extend these disclosure policies to loans for small businesses. The same information that is useful to consumers should and can be available to small business borrowers as well. To avoid future confusion in both lending and regulation, regulators should standardize disclosure policies across traditional and alternative lenders and apply them uniformly.

Endnotes

- ¹ In this report, BPC's Task Force on Main Street Finance generally refers to small businesses as those with fewer than 500 employees, the same standard used by the U.S. Small Business Administration and other federal agencies. However, other entities define small businesses using other metrics, such as annual revenues.
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Notes




Notes



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