Fordham Journal of Corporate & Financial Law

Volume 24 | Issue 1 Article 3

2019

Small Business Fintech Lending: The Need for Comprehensive Regulation

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Recommended Citation

Lenore Palladino, Small Business Fintech Lending: The Need for Comprehensive Regulation, 24 FORDHAM J. CORP. & FIN. L. 77 (2018).

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SMALL BUSINESS FINTECH LENDING: THE NEED FOR COMPREHENSIVE REGULATION

Lenore Palladino[*]

ABSTRACT

The 28.7 million small businesses in the United States—99% of all American businesses—are the backbone of the American economy. Historically, small businesses relied on community banks for their credit needs. Over the last decade, however, small businesses increasingly have turned to "fintech" lenders—nonbank lenders that are largely unregulated. Nonbank consumer lending is governed by consumer protection statutes, but nonbank small business lending is outside of any clear regulatory framework that would protect borrowers from potentially predatory practices. This Article argues that the optimal regulatory regime is a combination of both state authority over fintech lenders and inclusion of small business borrowers in federal consumer protection statutes.

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INTRODUCTION

The 28.7 million small businesses in the United States—99% of all American businesses[1]—are the backbone of the American economy.[2] The definition of a "small business" varies, but if we consider businesses with under 500 employees, they employ over half of all American workers and are drivers of economic prosperity.[3] Historically, small businesses relied on banks—particularly community banks—to fulfill their credit needs. Over the last decade, small businesses increasingly have been obtaining credit from "fintech" lenders—nonbank lenders that are largely unregulated. "Fintech," or financial technology, refers to technology firms that provide lending services outside of the traditional regulated banking context, using algorithmic decision-making processes rather than traditional credit scores and income verification.[4] While the rise of fintech lenders may open up credit opportunities to new borrowers, their rates and

1. "Small businesses" comprise a generically large category: if defined by all businesses with fewer than 500 employees, small businesses comprise 99% of all U.S. businesses and half of the American private-sector workforce. JPMorgan Chase & Co. Inst., *Small Business Data Dashboard* (Sept. 2016), https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-small-business-report-dashboard.pdf [https://perma.cc/G3V6-X2PA]. *See generally* Diana Farrell & Chris Wheat, THE UPS AND DOWNS OF SMALL BUSINESS EMPLOYMENT: BIG DATA ON PAYROLL GROWTH AND VOLATILITY (JPMORGAN CHASE & CO. INST., 2017); Mark E. Schweitzer & Brett Barkley, *Is "Fintech" Good for Small Business Borrowers? Impacts on Firm Growth and Customer Satisfaction* (Fed. Res. Bank of Cleveland, Working Paper No. 17-01, 2017).

2. Out of 28.7 million small businesses, 5.7 million are Main Street businesses, small- and medium-size suppliers to larger corporations, and high-growth startups. JPMorgan Chase & Co. Inst., *supra* note 1. *See generally* Karen G. Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulations* 2 (Harv. Bus. Sch., Working Paper No. 17-042, 2016).

3. Small businesses are the source of 60% of the net new jobs over the last two decades. *See* Mills & McCarthy, *supra* note 2, at 3, 14.

4. Though fintech is also growing inside traditional banking institutions as a way of conducting businesses, this Article focuses on the distinct nonbank entities that conduct lending, even though many nonbank fintech entities do partner with banks.

terms are often worse, and satisfaction with the borrowing experience is lower, as compared to traditional bank borrowing.[5] Fintech lending is not a niche sector; the U.S. Government Accountability Office (GAO) projects that the market could grow up to $122 billion by 2020.[6]

While non-bank consumer lending is governed by consumer protection statutes, non-bank small business lending is currently outside of any clear regulatory framework that would protect borrowers from potentially predatory practices.[7] The fact that a fintech borrower is covered by consumer protection statutes when he borrows $100,000 to remodel his house, but not when he borrows to capitalize his business, motivates the argument that small business borrowers should be covered under the consumer protection statutes. Small business borrowers generally do not have the sophistication of large commercial borrowers and have more in common with consumer borrowers than with large businesses.[8] The Treasury Department under the Obama Administration gave support to this perspective: "strong evidence indicates that small business loans under $100,000 share common characteristics with consumer loans yet do not enjoy the same consumer protections."[9] Small business borrowers are not covered under the consumer protection statutes that require clear disclosure of often-opaque lending terms, and that allow regulators to hold predatory behavior accountable.[10]

Fintech lending can, in principle, be a vital new source of credit to America's small businesses. Nonbank fintech borrowing increased because bank lending was severely constricted after the financial crisis,

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5. FED. RES. BANKS, 2017 SMALL BUSINESS CREDIT SURVEY: REPORT ON EMPLOYER FIRMS iv, 18 (2018).

6. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-18-254, FINANCIAL TECHNOLOGY: ADDITIONAL STEPS BY REGULATORS COULD BETTER PROTECT CONSUMERS AND AID REGULATORY OVERSIGHT 7 (2018).

7. At least five federal agencies have authority over traditional bank lending, along with state regulators, including the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, and the National Credit Union Administration. Letter from Am. for Fin. Reform, to U.S. Senate (Apr. 14, 2017) (on file with author).

8. *See* Barbara J. Lipman & Ann Marie Wiersch, Alternative Lending Through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups 5 (Fed. Res. Bank of Cleveland 2015).

9. U.S. DEPT. OF TREASURY, Opportunities and Challenges in Online Marketplace Lending 28 (2016).

10. SPENCER M. COWAN, PATTERNS OF DISPARITY: SMALL BUSINESS LENDING IN THE CHICAGO AND LOS ANGELES-SAN DIEGO REGIONS 30 (Woodstock Inst. 2017).

especially for the small-dollar loans ($250,000 and under) that small businesses typically seek.[11] Seventy-five percent of loan applications by small businesses are for amounts under $250,000; 55% are for amounts under $100,000.[12] The ongoing consolidation of the banking sector, in which larger banks are absorbing community banks, combined with the decline in small-dollar loan offerings by larger banks, created space in the last decade for fintech lending to thrive in the small business lending space. At the same time, technology advances allowed the advent of the larger nonbank financial marketplace. New firms use alternative data sources and "big data"-driven algorithms to evaluate creditworthiness.[13]

What is different about the fintech borrower experience? Unlike regulated brick-and-mortar banks, fintech firms provide and underwrite loans online. There are no standardized disclosure requirements or loan terms. Several studies have shown interest rates to be higher than those of comparable bank loans.[14] There is a risk that unregulated lending to small businesses could be predatory and unsustainable.[15] Small businesses report high levels of dissatisfaction with fintech lenders, as compared to bank lending, particularly regarding transparency of terms and the price of the loan.[16] Credit is a double-edged sword: small and new businesses need access to credit to survive, but risky credit that small companies cannot afford, or do not understand the terms of, can be devastating. High interest payments can drive small businesses into bankruptcy.

A clear regulatory framework has been slow to catch up to the industry's growth. As this Article will argue, the optimal regulatory regime is a combination of state authority and inclusion of small business borrowers (whose loans are below a certain threshold) in consumer protection statutes. State regulators should have the ability to regulate fintech lending to small businesses, building on a robust and diverse set of state policies governing nonbank financial entities. Alongside state law

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11. *See* Mills & McCarthy, *supra* note 2, at 5-6.

12. FED. RES. BANKS, *supra* note 5, at 6.

13. *See* Julapa Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 7 (Fed. Res. Bank of Phila., Working Paper No. 17-17, 2017).

14. *See, e.g.*, *id.* at 10. *See also* discussion *infra* Section III.

15. *See* Mills & McCarthy, *supra* note 2, at 86; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 11-613, REPORT TO CONGRESSIONAL COMMITTEES: PERSON-TO-PERSON LENDING: NEW REGULATORY CHALLENGES COULD EMERGE AS THE INDUSTRY GROWS 31 (2011).

16. FED. RES. BANKS, *supra* note 5, at 14.

and regulatory authority, the consumer statutes that are overseen by the Consumer Financial Protection Bureau (CFPB) should be updated to cover small business borrowers below a certain threshold.

An alternate regulatory framework has been proposed by the Office of the Comptroller of the Currency (OCC). The OCC proposes creating a "special purpose nonbank charter," (the Nonbank Charter Program) which would allow fintechs to operate nationally pursuant to private and entity-specific operating agreements with the OCC, rather than under federal banking law.[17] The OCC claims it is authorized to create such a charter under the National Bank Act (NBA).[18] This proposal is problematic because it would preempt state law by bringing fintech lenders under the national banking regulatory scheme, lowering borrower protections and the authority of state regulators to license and regulate fintechs in a number of states. This approach is also likely unauthorized because fintech lenders should not be considered banks under the NBA.

This Article makes the case for regulation of the fintech small business lending market and proposes a path forward for policymakers and regulators. Part I outlines the decline in bank lending to small businesses. Part II documents the rise of the fintech lending industry. Part III examines fintech lending and borrower outcomes, specifically for small business borrowers. Part IV focuses on the regulatory alternatives available for small business fintech lending and their competing arguments for authority.

I. THE DECLINE OF TRADITIONAL SMALL BUSINESS LENDING

Small-dollar bank loans to small businesses have been in decline,[19] though big bank lending to larger businesses recovered after the financial crisis. Community banks were small businesses' traditional lenders, and the consolidation of the community banking sector has been a core

17. Mills & McCarthy, *supra* note 2, at 8, 103.

18. *See* National Bank Act, 12 U.S.C. § 38 (2012).

19. Mills & McCarthy, *supra* note 2, at 24. A full discussion of the decline of community banks is beyond the scope of this paper. *See, e.g.*, Katy Milani, *Community Banking is Alive, Well: The Three Myths about Dodd-Frank and Community Banks*, ROOSEVELT INST. (June 8, 2017), http://rooseveltinstitute.org/community-banking-alive-well-three-myths-about-dodd-frank-and-community-banks/ [https://perma.cc/2Z98-C46H].

challenge for small businesses.[20] Even before the financial crisis, small banks began to lose market share to big banks as economies of scale and financial deregulation made it harder for small banks to compete on low-margin loans.[21] This section will explore the downward trend of bank lending to small businesses and the funding gap that remains.

The number of community banks fell from 14,000 in the mid-1980s to 5,000 today.[22] Even as overall bank assets have risen, the availability of credit for smaller loans has fallen.[23] The downward trend in small loans began a sharp decline during the financial crisis of 2008.[24] According to the Federal Deposit Insurance Corporation (FDIC), the number of bank-based commercial loans of $1 million or less fell every year since 2008, even while loans to larger businesses recovered.[25] New business startups also declined abruptly during the crisis and have not recovered,[26] and small businesses faced significant job losses.[27]

In 2017, less than 50% of small businesses reported receiving the full amount they applied for in credit across all lenders.[28] Karen Mills and Brayden McCarthy analyzed the small business funding landscape and found that, even years after the end of the recession, a significant funding

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20. *See* Julapa Jagtiani & Catharine Lemieux, SMALL BUSINESS LENDING: CHALLENGES AND OPPORTUNITIES FOR COMMUNITY BANKS 5 (Fed. Res. Bank of Chi. 2016).

21. *See id.* at 2.

22. Mills & McCarthy, *supra* note 2, at 5.

23. *Id.* This finding is not universal; Jagtiani et al. find that mergers involving community banks did not adversely affect lending to small businesses. *See* Julapa Jagtiani et al., *The Evolution of U.S. Community Banks and its Impact on Small Business Lending* 1 (Fed. Res. Bank of Phila., Working Paper No. 14–16, 2014).

24. *See* Jagtiani et al., *supra* note 23, at 2.

25. Mills & McCarthy, *supra* note 2, at 29.

26. There are numerous explanations, in addition to the credit constraints identified here, of why small business startups declined that are outside of the scope of this paper. They include rising student loan debt and a crash in consumer demand.

27. According to Mills and McCarthy:

> From the employment peak immediately before the recession through March 2009—the recession low point for private nonfarm employment—jobs at small businesses declined about 11%, while payrolls at businesses with 500 or more employees shrank about 7%, according to the Business Employment Dynamics (BED) database from the Bureau of Labor Statistics. This disparity was even more significant among the smallest of small businesses. Employment declined 14.1% in establishments with fewer than 50 employees, compared with 9.5% in businesses with 50 to 500 employees, while overall employment decreased 8.4%.

Mills & McCarthy, *supra* note 2, at 17.

28. FED. RES. BANKS, *supra* note 5, at 7.

gap remains, especially for micro loans.[29] As an example, Mills and McCarthy note that microbusinesses—those with revenues under $100,000—were half as likely to receive the funding they sought than firms with over $10 million in revenue.[30] Even though small business lending by large banks still maintains a high dollar volume, a declining portion of this lending is going to the loans on the smaller end, or firms on the newer end, of the spectrum.[31]

II. THE RISE OF THE FINTECH LENDING INDUSTRY

Fintech lending is a young industry. Before turning specifically to fintech small business lending, it is useful to understand the evolution of fintech lending as a whole and how it is different than bank-based lending. "Fintech" refers to an extremely broad set of activities. Frank Pasquale divides fintech into "incrementalist" fintech, which utilizes technology to provide standard financial services, and "futurist" fintech, in which the entire financial system is remade due to distributed technologies.[32] The

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29. *See* Mills & McCarthy, *supra* note 2, at 6; *see also* Karen G. Mills & Brayden McCarthy, *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game* 11 (Harv. Bus. Sch., Working Paper No. 15–004, 2014).

30. *See* Mills & McCarthy, *supra* note 2, at 41.

31. The shift has been rapid away from bank-driven small business lending in the startup phase of a firm:

> for instance, bank financing was used by just 12.3% of firms that were less than two years old at the time of the 2014 survey. By contrast, 18.4% of six- to ten-year-old businesses and more than 20% of older firms used business loans from banks or other financial institutions to get started. A 2015 survey by seven regional Federal Reserve Banks found that 58% of firms two years old or younger couldn't get all the financing they needed. Just 12.9% of Hispanic-owned firms and 15.2% of black-owned businesses used a business loan from a bank or financial institution to get started, compared with 19% of firms owned by whites.

See Ruth Simon & Paul Overberg, *Funding Sources Shift for Startups*, WALL STREET J., Sept. 28, 2016. Lisa Servon provides one illustration of the capital gap facing small businesses in New York City. She finds that there is a $6 billion unmet demand for business loans within the small and medium enterprise market, and that more generally only two-thirds of the demand for such loans is being met in the market. *See* Lisa Servon et al., *Estimating the Capital Gap for Small Businesses in New York City*, J. PUB. BUDGETING, ACCT. & FIN. MGMT. 451 (2011).

32. *Exploring the Fintech Landscape: Hearing Before the S. Comm. on the Banking, Housing, and Urban Affairs*, 115th Cong. (2017) (written testimony of Frank Pasquale, Professor of L., U. of Md.).

GAO defines fintech as the "use of technology and innovation to provide financial services."[33]

For fintech lenders, consumer lending has been the dominant focus of fintechs, starting with the original peer-to-peer lending platforms like Lending Club and Prosper, although a minority of lending went to small business borrowers.[34] Fintech firms have gained market share by differentiating themselves from traditional lenders in their speed of response to the prospective borrower, the way they use data, what data they use, and their ability to extend credit to those who are otherwise unable to access bank credit. The purpose of fintech lending, as described by the growing industry, is to expand opportunities for credit and help borrowers refinance and consolidate credit that may have higher interest rates, such as credit cards.[35]

One of fintech's distinguishing features is how, and how fast, it makes decisions about who is creditworthy. Most fintech lenders provide funding decisions within forty-eight to seventy-two hours.[36] To make decisions, they use data-rich algorithms with unconventional data sources[37] rather than the relationship-based and standard credit variables that traditional retail banking operations use, such as credit scores and income verification. In other words, fintech's innovative use of

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33. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 6, at 3.

34. *See generally* LENDING CLUB, LENDING CLUB STAT. https://www.lendingclub.com/info/download-data.action [https://perma.cc/PW7H-94 TN] (last visited Nov. 12, 2018).

35. *See, e.g.*, Marketplace Lending Association, *The Marketplace Lending Association Best Practices* (Sept. 16, 2018), http://marketplacelendingassociation.org/industry-practices/ [https://perma.cc/3GXP-BWH9].

36. *See* Mills & McCarthy, *supra* note 2, at 12.

37. Major online lenders such as SoFi and Kabbage claim to not use FICO scores at all when evaluating borrowers. The president of Prosper, another major lender, said that "Prosper gets 500 pieces of data on each borrower; the FICO score is just one data point." Penny Crosman, *Will Fintechs Kill the FICO Score?*, American Banker (June 14, 2016) https://www.americanbanker.com/news/will-fintechs-kill-the-fico-score [https://perma.cc/RES6-FE5T]. Small business lenders are pulling data from customer transaction data sources, real-time bank information, Quickbooks, IRS tax returns, and even reviews of businesses' products online. For consumer lending, fintech lenders are using data from utility payments, insurance claims, use of mobile phone and internet, and other demographic and personal details drawn from social networking sites. The use of such nontraditional data raises concerns about disparate impact as well as fair lending violations. *See* Jagtiani & Lemieux, *supra* note 13, at 7-8.

nontraditional data allows new borrowers or traditionally unqualified borrowers to access credit.

While this may be a benefit of fintech, no one can see into the "black box" of its decision-making.[38] Specifically, there could be violations of equal protection and fair lending laws, and there are numerous concerns about data privacy, use of data without the prospective borrowers' consent, and data security. Borrowers do not have any ability to review and correct data that is used in lending decisions, in contrast to borrowers' ability to review their credit score data from the credit bureaus.[39] Another challenge from the use of algorithms is the potential for disparate impact, as facially neutral data may be correlated with protected classes like race and age.[40]

The fintech sector is comprised of a wide variety of entity structures and business models. Fintech has evolved from platforms that served to connect "peers" to sophisticated firms with institutional investors, financial institution partnerships, and securitized transactions.[41] Many fintech firms affiliate with originating depository institutions—such as Lending Club's affiliation with WebBank—and there are a variety of hybrid models being developed.[42] Investors are pouring money into fintech startups, with almost $14 billion invested in 2016 alone, a 45% increase in funding in one year.[43] The Treasury Department projects that by 2020, origination volumes could reach $90 billion.[44]

Mills and McCarthy define three specific fintech business models: online balance sheet lenders, peer-to-peer lenders, and lender-agnostic

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38. *See, e.g.*, Frank Pasquale, THE BLACK BOX SOCIETY: THE SECRET ALGORITHMS THAT CONTROL MONEY AND INFORMATION 3, 17 (Harv. U. Press, 2015).

39. *See* U.S. DEPT. OF TREASURY, *supra* note 9, at 20.

40. *See* OFFICE OF CONGRESSMAN EMANUEL CLEAVER, II, 115TH CONG., FINTECH INVESTIGATIVE REP. (2018).

41. *See* Mills & McCarthy, *supra* note 2, at 54.

42. A full discussion of the myriad business models is beyond the scope of this paper. *See, e.g.*, Mills & McCarthy, *supra* note 2, at 54. There are signs that large banks have begun a new phase of in-housing or developing robust partnerships to have full fintech lending capabilities within their institutions. Mills and McCarthy claim that the industry has reached a new stage of maturity such that traditional institutions, such as hedge funds and community banks, are engaging in partnerships in order to capitalize on the initial success of the industry.

43. Aaron Klein, *The Coming "FinTech" Revolution*, 42 DEMOCRACY J. (Fall 2016), https://democracyjournal.org/magazine/42/the-coming-fintech-revolution [https://perma.cc/3EAG-VYYW].

44. *See* U.S. DEPT. OF TREASURY, *supra* note 9, at 9.

marketplaces.[45] Online balance sheet lenders function similarly to a cash advance.[46] This includes early lenders like OnDeck and Kabbage.[47] The loans are mainly short-term, and repayment is through regular deduction of a fixed amount of money or a percentage of sales deducted daily from the borrower's bank account.[48] "Peer-to-peer" lending platforms focus on consumer borrowing, targeting mid- to near-prime borrowers.[49] Backed by individual investors, these platform companies connect lenders and borrowers, and make loan decisions through proprietary algorithms.[50] They perform the traditional underwriting functions of evaluating credit and ability to pay.[51] Finally, there are marketplace lenders that serve to connect prospective borrowers with a variety of lenders with minimal transaction costs in order to help borrowers find the best loan, but charge fees as middlemen.[52]

Since the industry is young and there is no standard dataset, there are few studies that examine borrower outcomes. Julapa Jagtiani and Catharine Lemieux explore whether fintech lending lowers the price of credit for consumers as well as small business borrowers, how the use of alternate data sources compares to traditional risk factors, and how credit performance compares to similar bank loans.[53] They find that Lending Club (a major fintech lender) made credit available in geographic areas that suffered from declining credit supply, as measured by a loss of bank branches, and areas with highly concentrated banking markets.[54] For instance, "about 40% of Lending Club consumer loans were made in communities that had lost at least 5% of their bank branches."[55] Jagtiani and Lemieux also find that the correlation between Lending Club's proprietary loan grades and FICO scores has declined from 80% in 2007 to 35% in 2016, suggesting that Lending Club's own 'alternative data'

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45. *See* Mills & McCarthy, *supra* note 2, at 54-55.
46. *See id.* at 54.
47. *See id.*
48. Such entities often argue that they are not lenders and therefore not subject to state licensing and oversight laws. Specific legislation should affirmatively name Merchant Cash Advance financing entities as lenders and bring them under the scope of regulation proposed below.
49. *See* Mills & McCarthy, *supra* note 29, at 48.
50. *See id.*
51. *See id.* at 42.
52. *See id.* at 49.
53. *See* Jagtiani & Lemieux, *supra* note 13, at 3-4.
54. *See id.* at 21.
55. *See id.*

has become less similar to traditional FICO scores over time.[56] Finally, they find that some fintech borrowers have been able to get lower-priced credit than they would have been able to from traditional sources; this analysis is limited to loans made with the purpose of consolidation of other debt.[57] At the same time, the rate spread differential between borrowers with A-level loan grades and G-level loan grades (the lowest level) widened significantly to 20%.[58] The analysis found that Lending Club is charging significantly higher spreads in areas with higher levels of banking concentration.[59]

III. SMALL BUSINESS FINTECH LENDING AND BORROWER OUTCOMES

This section discusses the growth of fintech small business lending, borrower outcomes, and experience. This section also compares fintech small business lending outcomes with traditional bank lending outcomes. Jagtiani and Lemieux present data on the growth rate of small business fintech lenders, while noting that such lending still does not match aggregate bank lending.[60] They find that fintech lenders have been growing exponentially over the last decade. The 2017 Federal Reserve Small Business Credit survey shows a growing rate of small-dollar loans made by fintech lenders.[61] This survey breaks total borrowing by small businesses into bank and fintech components.[62] The survey found that 24% of small firms applied for financing with a fintech lender (up from 21% in 2016) and 71% of those applications were approved for a loan or line of credit, even while small firms continued to apply to banks for credit as well (47% applied to small banks for a loan while 49% applied to large banks).[63] Thirty percent of microbusinesses (those with under $100,000 in revenue) applied for a fintech loan, while only 6% of firms with over $10 million in revenue did so; large banks meet 58% of their credit needs.[64] Medium and high credit risk applicants were most successful at obtaining credit from online lenders (71%) as compared to

56. *See id.* at 25.
57. *See id.* at 28.
58. *See id.*
59. *See id.* at 30.
60. *See id.* at 1.
61. *See* FED. RES. BANKS, *supra* note 5, at iv.
62. *See id.* at 21.
63. *See id.* at iv.
64. *See id.* at 21.

large and small banks (35% and 47%, respectively).[65] These findings show that fintech lending is concentrated among small businesses and loans.

How do fintech small business borrowers evaluate their experience? According to the Federal Reserve's survey of small business borrowers, fintech lenders earned just a 35% net satisfaction score from successful small business borrowers.[66] Comparing this to the 74% satisfaction scores earned by small banks demonstrates the dramatic downward shift in satisfaction when borrowing from a fintech entity versus a traditional bank.[67] For online lenders, 52% of successful applicants who were dissatisfied with their experience cited the high-interest rate, while only 20% and 12% of borrowers cited high interest rates as a concern for large and small bank borrowing, respectively.[68] Other common reasons for dissatisfaction with the fintech borrowing experience included lack of transparency (15%) and unfavorable repayment terms (33%).[69]

Mark E. Schweitzer and Brett Barkley built on the 2017 Federal Reserve Small Business Credit survey by conducting a more robust comparison of online lending and traditional lending to small business borrowers, focusing on the resulting growth of employment and revenue as well as borrower satisfaction.[70] First, they found that businesses applying for fintech loans have characteristics making them more like firms that were denied financing from other sources than firms that received bank loans, which suggests that they are riskier borrowers.[71] Expectations of growth in revenue and employment are similar, whether a firm is securing bank or online financing, whereas both are distinct from firms that were denied financing.[72] However, business satisfaction with financing, which captures both the application process and the financing terms if they were approved for a loan, is much higher for firms with bank

65. *See id.* at iv.
66. *See id.*
67. *See id.* at 14.
68. *See id.*
69. *See id.*
70. *See* Mark E. Schweitzer & Brett Barkley, *Is "Fintech" Good for Small Business Borrowers? Impacts on Firm Growth and Customer Satisfaction* 1-2 (Fed. Res. Bank of Cleveland, Working Paper No. 17-01, 2017). Since the survey itself is limited, Schweitzer and Barkley are able to look at the different impacts of the different categories of lender through econometric specifications.
71. *See id.* at 8.
72. *See id.* at 9.

loans.[73] Schweitzer and Barkley find that "firms with bank financing are approximately 26.8 percentage points more likely to be satisfied with their lender(s) than firms with online financing (75% versus 48.2%)."[74] This is likely due to the fact that the terms of online loans are not required to be disclosed in the same manner as the terms of bank loans. Finally, they explore the effects on minority-owned firms. Minority-owned firms had higher satisfaction levels with fintech lenders, but this is explained by the low satisfaction minority borrowers had with banks to begin with.[75]

Another way to evaluate the borrowing experience for fintech borrowers is to take a qualitative approach. The Federal Reserve of Cleveland ran a series of online focus groups to uncover key issues about how small business owners are experiencing and interacting with the small business credit market.[76] They found that small business owners had difficulty comparing credit products, and many were uncertain or incorrect in answering questions evaluating their options when faced with choosing among loan products.[77] Virtually all participants in the focus groups said they want transparency of terms, and for loan terms to be expressed in ways that allow prospective borrowers to more directly compare loan offers.[78]

One of the most important considerations for the success of fintech lending is whether borrowers are paying back their loans at interest rates that they can afford to ensure that unaffordable interest rates do not drive them to default. The best evaluation of the efficiency of fintech is how available, affordable, and fair credit is. Troublingly, 52% of small business owners who borrowed from fintechs were dissatisfied with the interest rates on their loans.[79]

Several studies focus on the experiences of borrowers in a specific geographic area.[80] In one study, Weaver, Donaker Brown, and McShane present the challenges that arise from "alternative lenders" operating in a

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73. *See id.* at 10.
74. *Id.*
75. *See id.* at 11.
76. *See* Mills & McCarthy, *supra* note 2, at 105.
77. *See id.*
78. *See* Lipman & Wiersch, *supra* note 8, at 16.
79. FED. RES. BANKS, *supra* note 5, at 14.
80. ERIC WEAVER, GWENDY D. BROWN & CAITLIN MCSHANE, OPPORTUNITY FUND, UNAFFORDABLE AND UNSUSTAINABLE: THE NEW BUSINESS LENDING ON MAIN STREET 11 (2016).

"regulatory void" in California: high-cost loans with opaque terms.[81] Although the sample was extremely limited,[82] their analysis found that the average annual percentage rate (APR) for alternative loans was 94%, with one loan reaching 358%, far in excess of what is allowed under state usury laws.[83] High rates lead to their next conclusion: that the average monthly loan repayment is 178% of the net income available to the owners.[84] They also found that more than a quarter of small business borrowers had loans outstanding with multiple alternative lenders.[85] They note that while some lenders are offering responsible loan products, small business owners have trouble distinguishing between loans that are useful versus extractive to their business because there is a lack of requirements for disclosure or transparency.[86]

IV. HOW SHOULD FINTECH SMALL BUSINESS LENDING BE REGULATED?[87]

This Part will argue that the consumer statutes that regulate lending, generally at the federal level, should be amended to cover small business borrowers, with oversight by the CFPB, and that nonbank fintech lenders should be regulated and licensed at the state level.[88] Small business

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81. *Id.*

82. The authors work for the Opportunity Fund, the nation's largest non-profit micro-lender to small businesses. The Opportunity Fund refinances unsustainable loans; thus, their dataset is limited to businesses that approach them for refinancing. Their dataset was limited to 104 businesses that had applied to them for funding, who had received 150 alternative loans from 54 different lenders.

83. Weaver et al., *supra* note 80, at 11.

84. *Id.*

85. *Id.*

86. *Id.* at 2.

87. Other reforms that are beyond the scope of this Article: mandating that loan brokers operate as fiduciaries; industry-led reforms such as "Small Business Borrowers' Bill of Rights" which was announced in August 2015, led by Fundera, Funding Circle, Lending Club, the Aspen Institute, Small Business Majority, Accion, and Opportunity Fund. *See generally Signatories*, SMALL BUSINESS BORROWERS' BILL OF RIGHTS, http://www.borrowersbillofrights.org/signatories.html [https://perma.cc/86J6-65MZ] (last visited Sept. 21, 2018).

88. There is universal agreement that regulatory clarity is needed. The Obama Administration, research, and industry commentary have pointed out the need for clarity in the regulatory space, even though they come to different conclusions about the optimal regulatory structure. It is outside the scope of this Article to look at regulatory changes for the banking industry, which is developing an increasing scale of partnerships with

owners largely do not have the financial expertise or professional support to do a sophisticated analysis of their lending options. The fact that the vast majority of small businesses apply for loans under $250,000, and the majority of those apply for loans under $100,000, belies the assumption that these are "sophisticated" borrowers.[89] Eighty-seven percent of small business owners are relying on their personal credit scores and using personal collateral to finance their small businesses,[90] further blurring the line between consumer and business borrowing and demonstrating why protection is essential. The lack of protection of small business borrowers by the consumer protection statutes creates the opportunity for predatory lending.[91] Entanglement of an owner's personal credit history and his or her application for business lending can bring issues of racial discrimination into the process. Preliminary findings by Representative Emmanuel Cleaver included that small business owners of color are more likely to borrow from fintechs and that lenders "appear to be determining the race of the borrower even when it's not on the application."[92] Though it may be difficult to pinpoint the correct threshold at which a small business owner has enough financial sophistication to be regulated as a truly commercial borrower from nonbank entities,[93] it is nevertheless important to consider the option for microbusinesses (businesses under a certain revenue threshold) and startup entrepreneurs.

This Part considers the various regulatory alternatives available to appropriately govern the growing industry. It is crucial for state regulators to retain authority over fintech lenders (to both consumers and small businesses) in their states. At the federal level, consumer protection

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fintech lenders. Because the bank regulatory universe is already so complex, it requires a different set of considerations. New issues arise when the issuer of loans is partnering with a depository institution that faces standard bank regulation. However, many originating institutions pass loans off within a few days, thus transferring the risk back to the fintech entity and with it any regulatory oversight. FDIC issued guidance on such relationships but did not clarify how it would coordinate with other agencies. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 6, at 6-7.

89. Mills & McCarthy, *supra* note 2, at 3.

90. *See* FED. RES. BANKS, *supra* note 5, at 5.

91. *See* Mills & McCarthy, *supra* note 2, at 86.

92. Ian McKendry, *Are Fintechs Charging Minorities More for Business Loans?*, AM. BANKER (Oct. 16, 2017) https://www.americanbanker.com/news/are-fintechs-charging-minorities-more-for-business-loans [https://perma.cc/Z3UT-WV3Y].

93. One starting proposal would be to include all loans under $250,000 in the newly-revised statutes. However, pinpointing an exact threshold must be subject to empirical analysis and is beyond the scope of this paper.

statutes should be amended, and the CFPB should be granted rulemaking authority for the small business lending market. State regulators currently regulate nonbank lending in a variety of forms, such as mortgage lenders and payday lenders, and there are policies under development in several states to focus specifically on fintech lending, as described below.[94] Finally, this Part considers the alternate regulatory framework proposed by the OCC: the Nonbank Charter Program, in which the OCC issues a "special purpose" nonbank charter that fintechs can apply for in order to harmonize fintech lending and bank lending regulation. This proposal is not optimal principally because it would preempt state authority and leave borrowers still uncovered by core consumer protection statutes. Secondly, it is likely outside of the OCC's authority, as fintechs should not be considered banks under the NBA because they are not depositories. These arguments are described in detail below.

A. AMENDING CONSUMER PROTECTION STATUTES TO INCLUDE SMALL BUSINESS BORROWERS

Congress should enact clear borrower protections for small business borrowers by expanding the core federal consumer protection statutes to cover small business loans. In conjunction, Congress should formally expand the CFPB's jurisdiction over small business lending. One statute that should be amended is the Truth in Lending Act (TILA),[95] which can be amended to cover all borrowers under a certain threshold,[96] regardless of the purpose of such borrowing. Other key statutes to amend include the Equal Credit Opportunity Act (ECOA),[97] Fair Debt Collection Practices Act (FDCPA),[98] Fair Credit Reporting Act (FCRA),[99] and the Credit Practices Rule of Section 5 of the Federal Trade Commission (FTC) Act.[100] With the exception of the ECOA, the laws do not cover commercial borrowers, whether small or large businesses, because

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94. *See, e.g.*, S.B. 2865, 99th Gen. Assemb. (Ill. 2017), http://www.ilga.gov/legislation/BillStatus.asp?DocTypeID=SB&DocNum=2865&GAID=13&SessionID=88&LegID=96183 [https://perma.cc/QW5T-UVHF].

95. *See* 15 U.S.C. § 1602(i) (2012) (limiting coverage to lending to individuals "primarily for personal, family, or household purposes").

96. It is beyond the scope of this Article to determine the appropriate threshold.

97. *See* Mills & McCarthy, *supra* note 2, at 93-94.

98. *See id.* at 94.

99. *See id.*

100. *See* FTC Credit Practices Rule, 16 C.F.R § 444 (2018).

commercial borrowers are presumed to be sophisticated borrowers. And even though commercial borrowers are covered under the ECOA, data is not yet formally collected, so disparate impact claims cannot be evaluated.

The TILA requires lenders to provide fair and accurate loan cost information to allow borrowers to compare loan terms, bans advertising practices that are deemed deceptive or misleading, and gives borrowers the right of rescission (cancellation of the loan) for three days.[101] The TILA currently excludes business credit from its disclosure requirements; it applies to home loans, student loans, credit cards, and other consumer borrowing.[102] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[103] granted rulemaking authority under TILA to the CFPB. Amending the TILA to bring small business borrowing from nonbank institutions under the protection of the law would secure the ability of small business owners to obtain clear information on potential loans. Some industry insiders may argue that requiring such uniform disclosure would stifle innovation and hurt access to credit, while others in the industry are currently promoting similar disclosure outcomes and comparable loan information in their own self-regulating industry proposals.[104]

Congress should amend the CFPB's jurisdiction to give it explicit authority over the small business lending marketplace, in order to allow the CFPB to take enforcement actions for noncompliance with the consumer protection laws once it is amended to include small business loans. The core jurisdiction of the CFPB, as authorized by the Dodd-Frank Act, is over financial products that are "offered or provided for use by consumers primarily for personal, family, or household purposes."[105] This prevents the CFPB from using its authority to deal with predatory behavior that confronts businesses. The CFPB does have supervisory authority over a variety of non-depository financial institutions, such as payday lenders, student loan providers, mortgage lenders and servicers, as well as "larger participants" in the consumer lending market

101. *See* 15 U.S.C. 1635 (2012).

102. *See* 15 U.S.C. 1602 (i) (2012).

103. *See* Pub. L. No. 111-203 (2010).

104. *See Small Business Borrowers' Bill of Rights*, SMALL BUSINESS BORROWERS' BILL OF RIGHTS (2015), www.borrowersbillofrights.org [https://perma.cc/2KSR-MB2Y].

105. *See* 12 U.S.C. § 5481(5)(A) (2012).

generally.[106] The scope of the CFPB's jurisdiction could be defined to include any transaction for which the borrower is personally liable, regardless of the purpose of the loan. Or, it could be defined to cover small businesses taking out small loans, by creating a threshold for businesses based on the number of employees or the size of the loan. Former CFPB Director Richard Cordray supported the expansion of the CFPB's jurisdiction to include small businesses. In a March 2016 hearing, Cordray said:

> If I had my way—I don't have my way on many things—we would do what I did when I was Ohio attorney general and seek to protect not only individual consumers as our statute authorizes us to do, but also small businesses who often operate in the marketplace with no greater clout than an individual household does. If the Congress sees fit to give us that authority, we will aggressively pursue that. And it would help small businesses across the country.[107]

One immediate step for the CFPB is to implement Section 1071 of the Dodd-Frank Act, which is meant to allow the CFPB to collect data on small business lending.[108] Although Regulation B of the ECOA prohibits discrimination in business credit transactions generally, it does not provide a mechanism for determining if discrimination is taking place.[109] Section 1071 was intended to solve that by giving the CFPB the authority to collect data on small business borrowing by amending the ECOA to require the CFPB to collect data on credit applications by women-owned, minority-owned, and small businesses.[110] Section 1071 requires statistics on the type, purpose, and amount of loans applied for as well as what was approved, the type of action taken with respect to such applications, and other demographic information about prospective borrowers.[111] Although "the CFPB initially stated that it [would] act 'expeditiously'" to put such

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106. *See* 15 U.S.C. § 1602(g) (2012).

107. *The Semi-Annual Report of the Bureau of Consumer Financial Protection: Hearing Before the H. Comm. of Financial Services*, 114th Cong. 17 (2016) (statement of Richard Cordray, former CFPB Director).

108. *See* Mills & McCarthy, *supra* note 2, at 31.

109. *See* U.S. DEPT. OF TREASURY, *supra* note 9, at 38.

110. *See* Mills & McCarthy, *supra* note 2, at 31.

111. *See id.*

rules into place, no significant progress has been made.[112] Because the personal characteristics of the business owner are considered but there is no process to deal with discriminatory bias, it is possible that some of the challenges in the consumer sector are active in the small business borrowing sector as well.[113] Additionally, the algorithms that fintech firms are using have not been evaluated for their potential discriminatory impact.[114] The necessary approach is to fully implement Section 1071 and then conduct rigorous analysis of the data.[115]

The Credit Practices Rule, promulgated under Section 5 of the FTC Act, should also be amended to cover small business loans.[116] The FTC Act prohibits "unfair and deceptive acts or practices in or affecting commerce" and applies to both consumer and business transactions.[117] The Credit Practices Rule affords further consumer protection against abusive terms and conditions in credit contracts, including from nonbank lenders such as fintechs.[118] As FTC Chair Edith Ramirez stated at an FTC marketplace lending forum in June 2016:

> In light of the FTC's broad jurisdiction over non-bank financial entities and our decades of experience enforcing consumer lending laws, we want to ensure that consumers are treated fairly when they navigate this changing landscape. This includes ensuring that the same protections consumers have in traditional lending contexts also apply to marketplace lending.[119]

The FTC, however, has not yet taken steps to bring small business borrowers under the coverage of the Credit Practices Rule.[120] The Credit Practices Rule covers loans made to consumers who purchase goods or

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112. *See id.* at 31-32, nn. 49. Section 1071 was one of the few provisions in Dodd-Frank without a statutory deadline and has been delayed as a result. Congress should place a new deadline on its issuance.

113. *See* U.S. DEPT. OF TREASURY, *supra* note 9, at 38.

114. Mills & McCarthy, *supra* note 2, at 93.

115. To this end, the CFPB should additionally expand and make accessible its Consumer Complaints Database to small business borrowers.

116. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 6, at 36.

117. 15 U.S.C. § 45 (2012).

118. *See* Mills & McCarthy, *supra* note 2, at 92.

119. *See id.* at 50 (quoting Edith Ramirez, Chairman, FTC, Opening Remarks of FTC Chairwoman Edith Ramirez FinTech Forum Series: Marketplace Lending 3 (June 9, 2016)).

120. *See id.* at 86.

services for personal, family, or household uses.[121] This Rule could be amended to cover loans made to consumers for business purposes that are secured by personal collateral or that are under a certain size threshold.

B. State Regulation and Licensing of Fintech Lenders

States are the primary regulators of nonbank financial entities. All states require lending licenses for consumer lenders, though some limit what type of consumer lending must be licensed.[122] State financial regulators oversee nearly five thousand state-chartered banks and have the authority to regulate non-depository financial institutions that perform a range of functions in a range of markets, though state regulation was preempted for a set of financial institutions before the financial crisis.[123] The Coalition of State Banking Commissioners (CSBS) claims that Congress intentionally reserved the licensure and supervision of non-depository financial institutions to the states rather than pass federal chartering laws.[124] States, as part of their process for licensing non-depository institutions, evaluate their safety and soundness requirements and conformity to consumer protection statutes.

States have different legal regimes governing nonbank lending. Many states have laws that cap interest rates (state usury caps) and provide fair-lending protections.[125] This makes state regulators, and state law, best suited to evaluate the suitability of a fintech lender's program for the potential borrowers of a given state. Some states require nonbank lenders to obtain a license if they are issuing loans to borrowers in that

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121. *See id.* at 92.

122. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 6, at 36 n. 86.

123. State law has been preempted in the past by OCC preemption determination letters, although the OCC's preemption of state supervision of national bank operating subsidiaries was repealed in the Dodd-Frank Act. *See generally* Pub. L. No. 111-203, *supra* note 103.

124. *See* Letter from John W. Ryan, President & CEO, Conference of State Bank Supervisors, to Off. of the Comptroller of the Currency, Legis. and Reg. Activities Division, (Jan. 13, 2017), https://www.csbs.org/sites/default/files/2017-11/CSBS%20Comment%20Letter—OCC%20White%20Paper-Exploring%20Special%20Purpose%20National%20Bank%20Charters%20for%20Fintech%20Companies_0.pdf [https://perma.cc/8FJN-EDAE] [hereinafter *CSBS Letter*].

125. *See* NATIONAL CONSUMER LAW CENTER, USURY, https://www.nclc.org/issues/usury.html [https://perma.cc/YR65-6TEG] (last visited Nov. 12, 2018) (providing additional information on state usury laws).

state, and some states extend this requirement to small business lending.[126] Interest caps have been shown to be one of the simplest and most effective ways to protect borrowers from unaffordable loans.[127] The removal of this protection for fintech borrowers could cause an explosion of high interest rates. Many states provide greater fair-lending protection than do federal laws and provide privately enforceable protections against unfair and deceptive lending practices.[128]

As fintech lending has grown, some states and municipalities have taken it upon themselves to develop new regulations to govern the practices within their state. Illinois, led by the City of Chicago's Treasurer, has proposed licensing small business lenders, and proposed SB 2865, which would require lenders to disclose the APR of any prospective loan as well as the fees they charge, mimicking the requirements under the TILA.[129] The bill would also require lenders to

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126. California, Nevada, North Dakota, South Dakota, and Vermont require nonbank small business lenders to obtain licenses as well. *See* Jagtiani & Lemieux, *supra* note 20, at 16.

127. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA) allows federally insured state-chartered banks to use the interest rate limit imposed by their home state rather than the limit imposed by the state in which the loan is made. *See generally* Monetary Control Act of 1980, Pub. L. No. 96-221 (1980). The National Bank Act (NBA) extends this more broadly to all national banks. However, a recent federal appeals court decision, *Madden v. Midland Fund, LLC*, held that the National Bank Act does not preempt state interest rate caps once a national bank sells the loan to a third party. 786 F.3d 246, 251 (2d Cir. 2015). This has created uncertainty for holders of bank-originated assets, including marketplace lenders who originate loans through a bank. Indeed, the decision broke with a longstanding doctrine that a loan originated by a bank that was "valid when made" does not lose its preemption status when the loan is sold to a nonbanking entity. The U.S. Solicitor General, in a joint brief with the OCC, called the decision "incorrect," but argued that the Supreme Court should not hear the case, given the possibility that Midland Funding (the third party holding the loan) might win the case upon remand. In June 2016, the Supreme Court indeed declined to hear the case. Madden v. Midland Fund, LLC, 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

128. *See generally* Complaint, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:18-cv-02449 (D.D.C. Oct. 25, 2018) [hereinafter *Complaint 2018*].

129. S.B. 2865, 99th Gen. Assemb. (Ill. 2017), http://www.ilga.gov/legislation/BillStatus.asp?DocTypeID=SB&DocNum=2865&GAID=13&SessionID=88&LegID=96183 [https://perma.cc/QW5T-UVHF]; Small Business Financial Institute, *State of Illinois Turns its Sites on Online Lenders*, ADVICE ON LOAN, https://www.sbfi.org/state-of-illinois-turns-its-sights-on-online-lenders [https://perma.cc/HGE3-HHSG] (last visited Nov. 12, 2018).

determine the borrower's ability to repay before approving the loan.[130] Chicago's Treasurer, taking the initiative to look at small business lending, found that there were no preexisting regulatory solutions.[131] The city drafted regulations for business-to-business products that focused on transparency.[132]

New York has proposed similar licensing legislation, which would amend Section 340 of the Banking Law to add the requirement that a lender must be licensed to lend to either an individual or business for loans of $50,000 or less and expand the licensing requirement to entities that acquire loans from others.[133]

In addition to state legislation, the CSBS (the umbrella organization for state banking regulators) has adopted its own process to support state regulation of fintech lenders. In response to the OCC's Nonbank Charter Program Proposal (discussed *infra*), the CSBS has issued Vision 2020, a series of initiatives intended to streamline the process for regulation across states of fintech lending.[134] The stated goal is that by 2020, "state regulators will adopt an integrated, 50-state licensing and supervisory system, leveraging technology and smart regulatory policy to transform the interaction between industry, regulators and consumers."[135] The CSBS's redesign of the Nationwide Multistate Licensing System (NMLS)

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130. Small Business Financial Institute, *State of Illinois Turns its Sites on Online Lenders*, ADVICE ON LOAN, https://www.sbfi.org/state-of-illinois-turns-its-sights-on-online-lenders [https://perma.cc/HGE3-HHSG] (last visited Nov. 12, 2018).

131. *See* Emily Robbins, *Illinois May Be the First State in the Nation to Regulate Predatory Small Business Lenders*, NAT'L LEAGUE OF CITIES: CITIESSPEAK (Apr. 15, 2016), https://citiesspeak.org/2016/04/15/illinois-may-be-the-first-state-in-the-nation-to-regulate-predatory-small-business-lenders/ [https://perma.cc/J2TL-8GMM].

132. *See* Liz Farmer, *Are Predatory Business Loans the Next Credit Crisis*, GOVERNING THE STATES AND LOCALITIES: FINANCE (May 2015), http://www.governing.com/topics/finance/gov-predatory-business-loans-crisis.html [https://perma.cc/CU5P-WP3L].

133. Jonathan L. Pompan et al., *Proposed Change in New York Law Would License Fintech Loan Platforms*, VENABLE LLP (Mar. 2, 2017), https://www.venable.com/proposed-change-in-new-york-law-would-license-fintech-loan-platforms-03-02-2017/ [https://perma.cc/397G-3XUA].

134. CONFERENCE OF STATE BANK SUPERVISORS, *CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation* (May 10, 2017), https://www.csbs.org/csbs-announces-vision-2020-fintech-and-non-bank-regulation [https://perma.cc/EW9Q-BBEK].

135. CONFERENCE OF STATE BANK SUPERVISORS, *Vision 2020 for Fintech and Non-Bank Regulation* (Jan. 7, 2018), https://www.csbs.org/vision2020 [https://perma.cc/8NC4-WUD4].

is an attempt to streamline the multistate registration process and work toward uniformity in regulatory requirements where possible.[136] The NMLS will allow for one point of entry for registration and allow states to rely on the analyses from other states to more quickly engage with a fintech firm.

C. Office of the Comptroller of the Currency Special Purpose Nonbank Charter Program

An opposing regulatory framework is the OCC's Nonbank Charter Program,[137] in which the OCC would issue a special purpose bank charter for fintech companies that the OCC claims would "harmonize" the entry of these new unregulated firms into the marketplace, but would also preempt fintechs from state regulation.[138] As of October 2018, the OCC Comptroller Joseph Otting stated publicly that it is in discussions with, and vetting, several companies who are seeking such a charter.[139] One key problem with this proposal is the preemption of state law and the impact on the interest rate provision that would apply if fintech firms become nationally chartered, rather than state-licensed, entities.[140] Fintech companies would be able to act like national banks and import interest rates from their home state to all states where they do business.[141] Presumably, therefore, fintechs would incorporate in states where interest rate limits are nonexistent. Other concerns include the fact that state

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136. *See* CONFERENCE OF STATE BANK SUPERVISORS, *State Regulators Take First Step to Standardize Licensing Practices for Fintech Payments* (Feb. 6, 2018), https://www.csbs.org/state-regulators-take-first-step-standardize-licensing-practices-fintech-payments [https://perma.cc/Y7UV-F4VA].

137. *See generally* Off. of the Comptroller of the Currency, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective (Mar. 2016) [hereinafter *OCC Perspective*].

138. The OCC announced that it would begin accepting National Bank Charter Applications from Financial Technology Companies on July 31, 2018. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, POLICY STATEMENT ON FINANCIAL TECHNOLOGY COMPANIES' ELIGIBILITY TO APPLY FOR NATIONAL BANK CHARTERS (Jul. 31, 2018).

139. *Complaint 2018*, *supra* note 128, at 6.

140. *See* Letter from Lauren Saunders, Associate Director of the Nat'l Consumer L. Ctr. to Thomas J. Curry, Comptroller, Off. of the Comptroller of the Currency 7 (May 31, 2016).

141. *See generally* Charles M. Horn & Melissa R. Hall, *The Curious Case of* Madden v. Midland *Funding and the Survival of the Valid-When-Made Doctrine*, 21 N.C. BANKING INST. 1 (2017).

preemption would remove the ability of state regulators to directly license fintechs, and that the agreements that the OCC would make with a chartered fintech would remain private, excluding the fintech from public accountability.

The OCC has framed its policy as a mechanism to promote consistent application of laws and regulations among banks and fintech companies, and to make the federal banking system stronger by bringing fintech companies under the same framework as national banks.[142] The Nonbank Charter Program would allow the OCC to hold fintech entities to "the same rigorous standards of safety and soundness, fair access, and fair treatment of customers that apply to all national banks and federal savings associations."[143] In other words, the Nonbank Charter Program would "mak[e] certain that institutions with federal charters have a regulatory framework that is receptive to responsible innovation along with the supervision that supports it."[144] The OCC defines responsible innovation as: "[t]he use of new or improved financial products, services, and processes to meet the evolving needs of consumers, businesses, and communities in a manner that is consistent with sound risk management and is aligned with the bank's overall business strategy."[145] One principle of responsible innovation clarifies that it includes "fair access to financial services and fair treatment of consumers."[146]

Establishing the Nonbank Charter Program provides a route for entities to apply, but the OCC must still go through an approval process for each applicant.[147] The OCC proposed creating "operating agreements" with each fintech, which would be confidential.[148] The OCC could choose to impose specific requirements on uninsured special purpose banks, but it is unclear whether there would be any measure of public accountability for the operating agreements.[149] The agreements would, in theory, create

142. *See OCC Perspective*, *supra* note 137.

143. *See id.* at 2.

144. *Id.* at 2.

145. *Id.* at 5; *see also id.* for a further discussion of the "Guiding Principles for the OCC's Approach to Responsible Innovation".

146. *Id.* at 5.

147. *See generally* OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL DRAFT SUPPLEMENT: EVALUATING CHARTER APPLICATIONS FROM FINANCIAL TECHNOLOGY COMPANIES (2017) (providing a full description of the approval process).

148. *See id.*

149. *See id.*

a set of private laws that apply to those entities, but both application and enforcement would be impossible to monitor because the agreements would be confidential. There would be no way to assure that any rules would be applied in a uniform or impartial manner.

The OCC claims to have the authority to regulate fintechs as banks because fintechs engage in lending, one of the core banking activities under the NBA and Home Owners' Loan Act.[150] According to the CSBS, however, it is unsettled whether the NBA allows for a special purpose designation for financial entities that do not collect deposits without specific authorization by Congress.[151] The CSBS sued the OCC and Comptroller Tom Curry in April 2017 to enjoin the OCC from creating the Nonbank Charter Program on the grounds that the OCC would be going "far beyond the limited authority granted to it by Congress under the NBA and other federal banking laws."[152] Although the case was dismissed because the OCC had not yet affirmed it would issue charters, the CSBS filed suit again on October 25, 2018.[153] The case turns on whether the Nonbank Charter Program as understood would be for entities that truly are in the "business of banking," as the OCC claims.[154] The CSBS claims that the "business of banking" requires, at a minimum, engaging in receiving deposits.[155] Absent congressional authorization for a certain kind of bank that does not meet the qualifications of the business of banking, the CSBS claims the OCC's Nonbank Charter Program is unlawful.[156] There have been examples of attempts by the OCC to charter

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150. *See* National Bank Act, *supra* note 18, at 23, 25; *see also* Pub. L. No. 111-203, *supra* note 103.

151. *See Complaint 2018*, *supra* note 128, at 4.

152. Complaint at 2, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:17-cv-00763-JEB (D.D.C. 2017) [hereinafter *Complaint 2017*].

153. *See* Memorandum Opinion regarding the Defendants' Motion to Dismiss, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:17-cv-00763-JEB (D.D.C. 2017); *see also Complaint 2018*, *supra* note 128.

154. *See Complaint 2018*, *supra* note 128, at 4.

155. *Complaint 2017*, *supra* note 152, at 3. The lawsuit also focuses on an alleged violation of the Administrative Procedure Act by the OCC, which is beyond the scope of this Article.

156. *Complaint 2017*, *supra* note 152, at 3. Congress has authorized several special purpose banks that do not engage in deposit-taking: trust banks, bankers' banks, and credit card banks. *Id.* at 12.

institutions that were not in the "business of banking" per this definition, which were found to be unlawful.[157]

The NBA authorizes a special purpose national bank to conduct business nationally without being subject to state banking laws.[158] Under the NBA, core banking activities are defined as receiving deposits, paying checks, and lending money.[159] The question raised in the CSBS's complaint is whether an entity should be considered a bank if it engages in any one of these core activities, or if it needs to, at a minimum, accept deposits in order for the OCC to have the authority to designate the entity as a special purpose bank.[160] Congress mandates designated entities that do not take deposits as special purpose banks, such as bankers' banks and trust banks, but it is unclear whether the OCC can take this step on its own. The OCC's approach has been to view the NBA as allowing for new kinds of activities that fall within the broader scope of the business of banking. In describing how it would approach the Nonbank Charter Program, the OCC claims that it would consider the "permissibility" of new activities on a case-by-case basis.

How is the "business of banking" defined? The answer can be found by looking at what makes an entity cross the line into needing a banking charter rather than remain a nonbank entity. The CSBS claims that this line is crossed when an entity receives deposits, because then its business becomes a public concern.[161] The OCC claims that because fintechs lend money, which is one of the three core functions of banking, they fall within its purview.[162] The CSBS explains the confusion that would be

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157. Two federal courts struck down the OCC's attempts to charter institutions that were not engaged in the business of banking, holding that the OCC's chartering of special-purpose institutions exceeded the limits of its chartering authority. *See* Indep. Bankers Ass'n of Am. v. Conover, 1985 U.S. Dist. LEXIS 22529, at *34-36 (M.D. Fla. Feb. 15, 1985) (holding that special purpose "nonbank banks" are unlawful); *see also* Nat'l State Bank of Elizabeth v. Smith, No. 76-1479 (D.N.J. Sept. 16, 1977) (holding that special purpose trust banks were unlawful prior to Congress's specific grant of statutory authorization for such institutions), *rev'd on other grounds*, 591 F.2d 223 (3d Cir. 1979). Congress then authorized narrowly drawn amendments to the National Bank Act. In each case, Congress gave the OCC a carefully limited authority to charter a narrowly defined category of limited-purpose financial institutions, as shown by 12 U.S.C. §§§§ 27(a), 27(b), 1841(c)(2)(D), and 1841(c)(2)(F) (2012).

158. *Complaint 2018*, *supra* note 128, at 14.

159. *See id.* at 18.

160. *See id.*

161. *See CSBS Letter*, *supra* note 124, at 2.

162. *See id.*

created if fintech entities became true special purpose banks: since they would not have full-service charters, most banking laws, such as the Bank Holding Company Act, would not apply to them.[163] Would they be required to be Federal Reserve members? What would be their role in the payment system? One alternative is that the OCC could, as a condition of the charter, impose either adherence to state usury caps or follow the Military Lending Act and impose a 36% cap.[164] The CSBS claims that the OCC is overstepping its authority in this regard as well because preemption authority must come from Congress.[165] The CSBS believes that "the OCC has intentionally structured the special purpose nonbank charter to evade the application of certain federal banking laws."[166]

Another approach recommended by advocates is that the OCC Nonbank Charter Program could require that fintechs have "financial inclusion" plans and establish Community Reinvestment Act-like obligations for fintechs.[167] The OCC could also require fintechs to use debt-to-income ratios that do not exceed a certain threshold. In sum, the OCC proposal is problematic for two distinct reasons: 1) it would not increase borrower protection from predatory practices, and 2) it may be unlawful because fintechs should not be considered banks under the National Bank Act.

CONCLUSION

To best protect small business borrowers, nonbank lending to such borrowers should be included in the federal consumer protection statutes, and the small business lending market should be placed under the CFPB's jurisdiction. There is also ample reason to support robust state-level fintech regulation. Small businesses require access to credit and are the backbone of the American economy. In order for fintech lending to small businesses to support future American prosperity, a new framework is necessary.

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163. *See id.*

164. *See* 10 U.S.C. § 987 (2012).

165. The CSBS claims in its lawsuit that the OCC's program would thus violate the Supremacy Clause and the Tenth Amendment of the United States Constitution. *See Complaint 2017*, *supra* note 152, at 4.

166. *CSBS Letter*, *supra* note 124, at 3.

167. NATIONAL COMMUNITY REINVESTMENT COALITION, *Comments on White Paper-Exploring Special Purpose National Bank Charters for Fintech Companies* (Jan. 2017).