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Comment Letter to the CFPB for Information Regarding the Small Business Lending Market

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Via http://www.regulations.gov

Ms. Monica Jackson
Office of the Executive Secretary
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, DC 20552
FederalRegisterComments@cfpb.gov

Re: Consumer Financial Protection Bureau Request for Information Regarding the Small Business Lending Market, Docket No. CFPB-2017-0011

Dear Ms. Jackson,

The Milken Institute appreciates the opportunity to comment on the Consumer Financial Protection Bureau's (CFPB) request for information (RFI) regarding the small business lending market.[1]

The Milken Institute (the Institute)[2] is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs, and improve health. The Center for Financial Markets (CFM)[3] promotes financial-market understanding and works to expand access to capital, strengthen and deepen financial markets, and develop innovative financial solutions to the most pressing global challenges.

Small businesses are the backbone of the American economy and contribute substantially to U.S. economic growth and productivity. Just under 28 million businesses in the United States are classified by the U.S. Small Business Administration as a "small business." These businesses employ nearly half of America's workforce.[4] Nearly three-quarters of U.S.-based small businesses are operated as sole proprietorships—businesses that are owned and operated by one person only.[5] Given the economic role small businesses play in the U.S., understanding this portion of economic activity and growth is vital to fostering an enabling environment where startups and more mature small businesses can flourish.

And yet, we are often left with incomplete data comprised of approximations and estimates that oftentimes have to be relied upon. Accurate data on the small business lending environments at the local, state, and national levels, in particular, is hard to come by and leaves policymakers and regulators with the task of developing policies and guidance based on rough estimates from an opaque, yet gigantic sector of the economy. At a time marked by the proliferation of data and

[1] Available at: https://www.gpo.gov/fdsys/pkg/FR-2017-05-15/pdf/2017-09732.pdf
[2] Available at: http://www.milkeninstitute.org/
[3] Available at: http://www.milkeninstitute.org/centers/markets
[4] N/A, Small Business Profile, U.S. Small Business Administration, 2016. Available at: https://www.sba.gov/sites/default/files/advocacy/United_States.pdf
[5] Caron Beesley, Sole Proprietorship - Is this Popular Business Structure Right for You? U.S. Small Business Administration, February 27, 2013. Available at: https://www.sba.gov/blogs/sole-proprietorship-popular-business-structure-right-you

advanced analytical tools and capabilities, the appropriate course(s) of action to foster, sustain, and grow small businesses is unclear due to the lack of data.
The CFPB's recent RFI seeks to comprehensively address the current shortcomings in small business lending data collection efforts and offers regulators, policymakers, and industry stakeholders the potential ability to more effectively tailor resources and guidance to support small business ecosystems—especially underserved small businesses—at the local, state, and/or national levels.

While we are encouraged to see efforts being made to provide for additional transparency and understanding of the small business lending environment through enhanced data collection, we are also cognizant of what this new data request could mean for lenders of all sizes.

The key takeaways of our comments are:

- ***Additional data could help remove structural barriers in the small business lending space, particularly for minority- and women-owned small businesses.*** Additional data could illuminate the small business lending space leading to more accurate information, tailored financial products and services, and more right-sized policy and regulatory efforts particularly focused on underserved small business communities.

- ***Enhanced data collection could reduce or eliminate the application of the Bayesian Improved Surname Geocoding (BISG) method to conduct fair lending analysis in the small business lending market.*** Additional data covering a small business lenders loan portfolio could remove the need for the use of the proxy method to determine fair lending compliance.

- ***Agencies should review current definitions, streamline/consolidate data collection requirements, and ensure no additional burden before pursuing a new definition of a "small business."*** There are far too many definitions and reporting requirements imposed on small business lenders at the federal level leading to potentially duplicative and overlapping processes. Efforts to add yet a further definition should be tempered, and agencies should develop efforts internally to assess what definitions and reporting requirements remain practical in this day and age.

- ***The CFPB's RFI will disproportionately impact different types of lenders operating in the small business space.*** Community banks, credit unions, community development financial institutions, alternative finance providers, among other sources, are on the front lines serving small business credit needs. Although smaller lenders may show a rationale for being exempt from the additional compliance due to cost, that is not prudent. As such, rather than provide blanket exemptions to certain smaller lenders, the CFPB should review legacy compliance and reporting requirements to determine whether out-of-date or inadequate in the current economic environment.

- ***The CFPB needs to clarify the type of small business owner and information required to avoid problems that may be raised in the Bureau's attempts to collect certain data from small business lenders.*** The CFPB should provide clarity to ensure proper data collection and that the data collected is accurate.

Additional data could help remove structural barriers in the small business lending space, particularly for minority- and women-owned small businesses.

Former Treasury Secretary Jack Lew once stated that roughly 8,000 small and micro businesses seeking finance are declined every day in the U.S. – more than two million annually. "When credit-worthy companies cannot get capital, it is a damper on job creation and economic growth," Lew remarked.[6]

A separate study conducted by the Association for Enterprise Opportunity found that roughly one-third of small businesses declined for financing are actually creditworthy using various underwriting methodologies *currently available* in the market.[7]

The reasons for the declines are manifold. That said, the small business data collection effort proposed by the CFPB can play a role in helping public and private stakeholders better understand the small businesses in their localities, their needs and preferences, and better tailor resources and support to enhance lending capacity to underserved, minority- and women-owned small businesses in particular.

Based on past discussions and analyses focused on enhancing capital access to minority-owned small businesses, the Milken Institute Center for Financial Markets has identified areas where enhanced data collection could play a significant role in reducing the number of declines by traditional financial institutions, while enhancing the viability of underserved small businesses. These include:

A. Reduced Product Mismatch & More Tailored Technical Assistance. Requiring lenders to collect data that describes the small businesses' needs and purpose for financing could further inform lenders, technical assistance and business resource specialists of any deficiencies. Without requiring lenders to remedy, the information alone could result in the provision of more compatible financing products (debt *and* equity), as well as more tailored technical assistance fit to the needs of each small business borrower based on the data collected.

B. Enhanced Responsiveness from Local, State, and Federal agencies. The lack of data can result in a misallocation of resources and ineffective responses in efforts to reduce impediments to small business financing and growth. Enhanced data collection efforts offer policymakers and regulatory officials with the opportunity to make more informed decisions and better tailor resources and support to certain industries or areas in particular need of additional local, state, or federal support.

C. Reduced Reliance on "Cookie-Cutter" Underwriting Processes. Efforts by the CFPB to further illuminate the small business lending space could provide both bank and nonbank lenders with additional insight into the wants and needs of their localities or places of operation. Rather than simply relying on a personal FICO score and past financial statements, small business lenders

[6] Jacob Lew, Remarks on Growing America's Small Businesses at the Capital Access Innovation Summit, U.S. Department of the Treasury, June 10, 2013. Available at: https://www.treasury.gov/press-center/press-releases/Pages/jl1979.aspx
[7] Association for Enterprise Opportunity Micro Capital Task Force, Micro Capital Task Force: Moving Money to Main Street. Available at: http://www.aeoworks.org/pdf/MCTF_Congressional_Briefing_One-Pager.pdf

may be able to incorporate the additional data made publicly available by the CFPB to adjust and make improvements to their underwriting models.

We would encourage the CFPB to clarify what "type of action taken" under subsection 704B(e)(2)(D) in Section 1071 of Dodd-Frank means, and would caution against the CFPB adopting a standardized set of reasons for denial for small business lenders given the differences in lenders' approaches and metrics used in determining whether a small business qualifies for financing.

Enhanced data collection could reduce or eliminate the application of the Bayesian Improved Surname Geocoding (BISG) method to conduct fair lending analysis in the small business lending market.

The CFPB's current reliance on the BISG method—which combines geography and surname-based information to determine the probability for race and ethnicity—is based largely on probabilities. Nevertheless, the Bureau has used this method to enforce penalties for discrimination in the past.

That method, however, has been called into question by a variety of stakeholders. A study by Charles River Associates and the American Financial Services Association published in November 2014 found that the BISG model, among other models used by various regulators, "[is] conceptually flawed in their application and subject to significant bias and estimation error" resulting in "overstated disparities and overstatements of alleged consumer harm."[8] A separate report prepared by the Republican staff of the U.S. House Committee on Financial Services covering auto finance lending found significant discrepancies in the data obtained through use of the proxy method when compared to other, more reliable models.[9]

If the BISG model is applied to the small business lending market, the discrepancies and relative arbitrary decisions rendered by the CFPB could have a chilling effect on the market. That said, in its most recent annual fair lending report,[10] the landscape white paper,[11] and the RFI, the Bureau does not mention whether the proxy model will be used to determine whether there are fair lending infractions in the small business lending market.

There may be no reason to use the model at all assuming the CFPB moves forward on its RFI to actual regulation. Given the type of data that the CFPB is requesting there should be a sufficient amount of data derived from this process to remove the need to apply the BISG model to enforce fair lending requirements.

[8] Arthur Baines and Dr. Marsha Courchane, Fair Lending: Implications for the Indirect Auto Finance Market, Charles River Associates, November 19, 2014. Available at: https://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf

[9] Republican Staff of the House Committee on Financial Services, Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending, U.S. House Committee on Financial Services, November 24, 2015. Available at: https://financialservices.house.gov/uploadedfiles/11-24-15_cfpb_indirect_auto_staff_report.pdf

[10] N/A, Fair Lending Report of the Consumer Financial Protection Bureau, U.S. Consumer Financial Protection Bureau, April 2017. Available https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201704_cfpb_Fair_Lending_Report.pdf

[11] N/A, Key Dimensions of the Small Business Lending Landscape, U.S. Consumer Financial Protection Bureau, May 2017. Available at: http://files.consumerfinance.gov/f/documents/201705_cfpb_Key-Dimensions-Small-Business-Lending-Landscape.pdf

The Milken Institute recommends the CFPB provide additional guidance as to whether or not the Bureau intends to use the BISG method to conduct fair lending analyses on small business lenders if final rules are promulgated under Section 1071 of the Dodd-Frank Act.

Agencies should review current definitions, streamline/consolidate data collection requirements, and ensure no additional burden before pursuing a new definition of a "small business."

In the RFI, the Bureau states that it could potentially develop an alternative definition of small business "that meets the criteria outlined in section 632 of the Small Business Act and is tailored to the needs of section 1071…."

We would note that there are currently more than 40 "small business" definitions at the federal level.[12] In addition, the North American Industry Classification System (NAICS)—which contains industry-specific size standards the SBA utilizes to determine program eligibility—now tops more than 1,000 industry classifications across 18 different sub-industry activities.[13]

Similarly, the barometer most often used to decide whether a business is small is if it has 500 or fewer employees, which encompasses more than 99 percent of all small businesses in the U.S. This figure has become the prevailing small business size standard used by certain federal agencies.

To be fair, the SBA has tried multiple times to revise current size standards but has been met with opposition from various industries and trade groups. As a recent Congressional Research Service (CRS) report found, it's far easier for the SBA to increase rather than decrease their size standards.[14]

Beyond the multiple definitions and classifications of a small business, there are roughly 20 federal agencies and departments that already collect all sorts of data on small businesses, in addition to non-government organizations' small business data collection efforts.[15]

At a time when the federal government is looking to review and modernize certain regulatory structures and frameworks, perhaps also the time has come to assess whether the current small business definitions and data collection regimes need a bit of tailoring themselves?

Before any new definition of a small business, the Milken Institute recommends the CFPB and other federal agencies undertake a review of current small business definitions and reporting requirements to determine their relevancy and applicability in today's economy. Based on the review, agencies should initiate efforts to consolidate the number of definitions where applicable and streamline reporting requirements to prevent duplicative and overlapping methods of reporting.

[12] In June 2016, the White House convened a meeting co-hosted by the Milken Institute and the U.S. Small Business Administration focused on the various challenges and barriers facing African American- and Hispanic-owned small businesses. One participant stated that there were 42 definitions of a "small business" at the federal level.
[13] Robert Jay Dilger, Small Business Size Standards: A Historical Analysis of Contemporary Issues, U.S. Congressional Research Service, July 21, 2017. Available at: https://fas.org/sgp/crs/misc/R40860.pdf
[14] Id.
[15] Available at: https://www.sba.gov/sites/default/files/Small_Business_Data_Resources.pdf

The CFPB's RFI will disproportionately impact different types of lenders operating in the small business space.

Nearly three-quarters of small businesses apply for $250,000 or less in financing, with 60 percent of small businesses applying for less than $100,000. This is the same space from where certain financial institutions continue to retreat due to heightened regulatory requirements, particularly in the aftermath of the most recent financial crisis.

It has also become incredibly costly to service small dollar loans. Processing a $50,000 loan is nearly equivalent to the cost of processing a $1 million loan.[16] It comes as no surprise then that financial institutions are preferring to service larger loans to larger businesses – up four percent since the financial crisis while small business lending has fallen by 20 percent.[17] As a result, there is a significant capital gap that exists for small businesses seeking $250,000 or below in financing.

Smaller lenders – community banks, credit unions, community development financial institutions, alternative finance providers, among others - have filled in, expanded in, or continue to serve in this space providing an essential capital lifeline to small businesses.

Given smaller lenders' proximity and relationships with small businesses, particularly those that operate in underserved areas, the data collection requirements have the potential to (or will) disproportionately impact smaller financing firms. That said, given the preponderance of financial institutions serving the small business space, and in order for the CFPB to obtain accurate data from a diverse amount of small business lenders, providing exemptions to any financial institutions does not make sense at this time.

The Milken Institute recommends the CFPB not provide exemptions to different types of small business lenders from collecting and reporting such data but urges the Bureau to review current compliance requirements imposed on smaller lenders to determine which requirements could be reduced or eliminated to alleviate concerns related to small business data collection compliance costs.

The CFPB needs to clarify the type of small business owner and information required to avoid problems that may be raised in the Bureau's attempts to collect certain data from small business lenders.

Section 1071 of the Dodd-Frank Act requires small business lenders to collect information pertaining to the race, sex, and ethnicity of the principal owner of the small business. The Institute would note, however, that collecting information pertaining to the principal owner of a small business is much harder said than done when you consider the following:

[16] Brayden McCarthy and Karen Mills, The State of Small Business Lending: Innovation and Technology and the Implications for Regulation, Working Paper 17-042, Harvard Business School, 2016. Available at: http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf

[17] Brayden McCarthy and Karen Mills, The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game, Working Paper 15-004, Harvard Business School, July 22, 2014. Available at: http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf

A. The principal owner of a small business is not actually a person.
What if the principal owner is a legal entity, a subsidiary of a much larger corporation, owned by a foreign or public entity? How does Section 1071 apply to non-persons who own/ have a controlling stake in the small business?

B. The person applying for credit is not the principal owner.
The CFPB's RFI seems to assume that those who apply for small business credit are the principal owners. Depending on one's definition of "small business" this may not be the case.

This could be problematic if the person filling out the application submits incorrect data, or submits data in an attempt to fraudulently access certain programs that are supposed to benefit minority- and women-owned small businesses. While a lender can effectively determine whether an applicant is filing incorrect financial information based on examination of past financial statements and other metrics, it is unclear whether lending institutions can determine whether the data submitted on race and ethnicity, for instance, is valid. However, any attempts to ensure validity of the designated race and ethnicity must guard against any real or perceived barriers to access.

C. The person filing the application does not actually have to report what the CFPB is looking for.
Subsection 704B(c) states that an applicant for credit "may refuse to provide any information requested pursuant to subsection (b) in connection with any application for credit." In other words, applicants for credit have the right to refuse to indicate to the financial institution whether the business is "women-owned, minority-owned, or small business."

If the whole point of adding Section 704B to the Equal Credit Opportunity Act (ECOA) was to ensure proper enforcement of fair lending laws in the U.S. through lender collection of additional data on the small business applicant, this subsection effectively undermines the very reason for the inclusion of Section 704B in ECOA.

D. An open-ended request for additional data creates too much uncertainty in the process.
Subsection 704B(e)(2)(H) states that the CFPB may also request any additional data that it determines would help fulfill the purposes of Section 704B of ECOA. It is unclear, at this time, what additional data the CFPB would ask for, whether it would apply to every institution in compliance with this subsection or on an institution-by-institution basis. Any additional metrics will likely lead to a protracted application process, further delaying a borrower's ability to obtain credit to grow the business.

E. The person filing the application may not understand the amount of credit he/she actually needs.
The amount of credit applied for and approved are two important data points, but we would caution the CFPB, and other regulators, from using this data to fault lenders for failing to fulfill the credit demand of small businesses. Simply put, small business owners may not know of (or misstate) the level of credit they need. The lack of technical assistance or ineffective providers of technical assistance can contribute to small business owners overstating (or understating) the amount of credit they actually need.

The Milken Institute appreciates the opportunity to comment on the CFPB's request for information regarding the small business lending market. Please let us know if we can provide any additional information, and we would be pleased to continue this discussion in person.

Regards,

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