eta ELECTRONIC TRANSACTIONS ASSOCIATION

1620 L Street NW, Suite 1020
Washington, DC 20036

202.828.2635
electran.org

March 2, 2020

Delegate Dereck E. Davis
Chair, House Economic Matters Committee
231 HOB
6 Bladen St
Annapolis, MD 21401

RE: Opposed – H 1478 (Merchant Cash Advance Prohibition)

Dear Chair Davis:

On behalf of the Electronic Transactions Association (ETA), we appreciate the opportunity to share our thoughts regarding H 1478. ETA supports providing small businesses with the access to capital they need to be successful, including providing borrowers with the best information to compare costs and make informed decisions. ETA favors increasing, not decreasing choices in small business financing – allowing small businesses to select the best product that suits their needs. ETA opposes Maryland banning an entire line of long-established financing options. Instead, we support pursuing approaches to strengthen protections for small business, while preserving the access to capital that allows those same businesses to thrive.

ETA is the leading trade association for the payments industry, representing over 500 companies that offer electronic transaction processing products and services, including financial institutions, transaction processors, payments networks, and others. ETA also has members that are engaged in online lending for commercial enterprises, primarily small businesses, either directly or in partnership with other lenders.

Overview of Online Small Business Financing Models

Many online small business financing companies share a number of similarities that include:

- Providing borrowers with efficient access to credit that relies on existing data streams and automation, rather than a lengthy form process, often providing funding decisions within 24 to 72 hours.
- Offering small loans with short-term maturities, between 6-18 months, although some up to 36 months.
- Using automated online loan applications (either with data they already have on the customer or data that the customer provides them) and have no retail branches.
- Utilizing electronic data sources and technology-enabled underwriting models to automate processes such as determining a borrower's identity or credit risk. The data sources used include traditional underwriting inputs, but also real-time business accounting, payment and

sales history, online small business customer reviews, and other non-traditional or alternative data.[1]

While online small business lenders have many different types of business models, two major business models have emerged.

The first type of primary business model for online small business lenders is as a direct lender and, where applicable, as a state licensed lender in those states requiring licenses. In such states, direct lenders originate loans on their own books and may be required to obtain licenses or register with the individual states in which they lend. These direct lenders do not rely on depository institutions to originate loans, but rather make loans themselves and either hold those loans in their own portfolios and rely on capital sources including credit facilities, whole loan sales, and securitizations to fund their originations.

The second type of primary business model for online small business lenders is the bank partnership or lending platform model. Lending platforms provide services for an issuing depository institution to process loans and then purchase the loans to hold on their books or for sale to investors as whole loans or by issuing securities such as member-dependent notes. In this model, the issuing depository institution originates loans to borrowers that apply on the online platform. The loans are subsequently held by the issuing depository institution for a period of time (typically 1-21 days) and then purchased by the lending platform or directly by an investor through the platform.

Under this model, lending platforms are not the lender because they do not originate the loans. Rather lending platforms are technology or outsource vendors rather than the actual lender. The issuing depository institution is expected by its banking regulator to oversee the lending platform as a vendor. An online lending platform that meets the statutory definition of a bank service company or a third-party service provider to one or more depository institutions may also be subject to the regulation and examination authority of the relevant federal banking agencies under the Bank Service Company Act.[2]

As the market develops and becomes more mature, both direct lenders and lending platforms are altering these frameworks to allow more flexibility to provide credit to small businesses. Some direct lenders have developed hybrid models, selling some whole loans to institutional investors while retaining servicing responsibilities. The combination of data-driven underwriting, automated and online operations, a lack of legacy systems, and investor capital has allowed online small business lenders to make third-party arrangements to fill a need in the small business lending market.

[1] *See* U.S. Department of Treasury, *Opportunities and Challenges in Online Marketplace Lending*, p.5 (May 10, 2016).
[2] 12 U.S.C. §§ 1861-1867.

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Overview of Online Small Business Financing Products

The small business financing market has a number of participants who help to provide small businesses with access to funding by matching them with lenders or by providing a variety of financing options Small business financing products range from fixed term loans, open-ended lines of credit, and the purchase of future accounts receivables.

Referral Partners

Referral partners may perform a variety of services, including assisting borrowers to identify potential financing options, generating leads for lenders, and in some cases, assisting in the application process. There are a few types of referral partner business models in the market today, but the common thread among referral partners is that they do not make credit decisions on credit applications. This important distinction will be discussed in more detail later in this letter.

One prominent referral partner model is the marketplace matchmaking platform model. Marketplace platforms provide a portal where small businesses can go to use the resources and partnerships of the referral partner to help small businesses with certain aspects of getting commercial financing. In many cases, the small business fills out (or at times, the company pre-fills on the small business's behalf by using data from their financial management software) an application and is given a choice of tailored financing available from a variety of financiers. The credit decisions and financing are made by independent, third party financiers including traditional lenders, online lenders, companies that purchase future receivables and SBA-approved lenders. Those participating financiers may offer term loans, SBA loans, lines of credit, purchasing of future account receivables, invoice financing and small business credit cards. The criteria is established by the participating financier on the platform to give a small business a clear understanding of the range of financing options available to them. The small business chooses its preferred choice of financing product and financier and the platform forwards the application information to the financier. The financier makes the credit decision on the application.

Marketplace platforms often serve as highly valuable price and product comparison tools for small businesses. Marketplace platforms play a key role in helping to match small businesses and their individual credit needs to financier that can provide products which meet those credit needs.

Purchase of Future Account Receivables or "Merchant Cash Advance"

The purchasing of future account receivables are not loans, but rather, they are a sale of a portion of the small businesses' future credit and/or debit card receivables. When companies provide funds to businesses in exchange for purchasing a percentage of the businesses' daily credit card income, those funds come directly from the processor that clears and settles the credit card payment. A company's remittances are drawn from customers' debit and credit-card purchases on a daily basis until the obligation has been met. Many purchasers form partnerships with payment processors and take a percentage of a merchant's future credit card sales. Purchasers offer an alternative to businesses who may not qualify for a conventional commercial loan and provide flexibility for

merchants to manage their cash flow by fluctuating with the merchant's credit and/or debit card sales volume.

The distinguishing characteristic of a purchase of account receivables is that there is no fixed scheduled payment amount or term. When the merchant makes a sale via credit and/or debit card, a percentage of the transaction is forwarded to the purchaser. This continues until the total amount of purchased receivables has been paid. The MCA provider receives the purchased receivables in one of the following ways: (i) the merchant's processor forwards the purchased receivables directly to the funder; (ii) the merchant's receivables are deposited into a lockbox account that forwards the purchased receivables to the provider and remits the balance to the merchant; or (iii) the provider is notified of the amount of the credit card receivables generated and the funder debits the purchased portion from the merchant's bank account.

For many small businesses, the purchase of future account receivables is an alternative to a traditional commercial loan because the transaction does not require personal guarantees from the business owner only a performance guaranty. The performance guaranty requires that the owner ensure that the business entity complies with all of the terms and conditions of the purchasing agreement. Moreover, unlike a commercial loan which has an absolute right to repay, in the event a business closes, and does not breach the agreement, the business is not held responsible to pay the remaining balance on the agreement. The purchaser takes a risk that a business may close. For example, in May 2018, when Maryland was stuck by severe storms and flooding, any small business that had to close its doors due to the disaster would not be obligated to pay the outstanding balance on the agreement because the business closed, without breaching the contract, as the purchaser assumed the risk in purchasing the future account receivables.

The purchase of future accounts receivable is a crucial small business finance lifeline, particularly for new enterprises without pre-established lines of credit with banks. There are many alternatives to restricting customer choice through an outright ban on such a critical financing solution, and the industry would be an eager participant in crafting thoughtful legislation that protects small business and preserves the access to capital that so many of those businesses need.

Thank you for the opportunity to participate in the discussion on this important issue. If you have any additional questions, you can contact me or ETA Senior Vice President, Scott Talbott at stalbott@electran.org.

Sincerely,

Tom Bloodworth
State Government Affairs
Electronic Transactions Association
TBloodworth@electran.org
(731) 414-3415