Testimony before the Joint Economic Committee
Hearing on "Breaking through the Regulatory Barrier: What Red Tape Means for the Innovation Economy"
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I would like to thank Chairman Paulsen, Ranking Member Heinrich, Vice Chairman Lee and all of the distinguished members of the committee for inviting me to testify today. I am honored to be here to talk about my experience supporting safe and affordable access to credit for America's small businesses and entrepreneurs.

From 2012 to 2017, I served in President Obama's Administration, first at the Small Business Administration and then at the U.S. Treasury Department where I was the Deputy Assistant Secretary for Small Business, Community Development, and Housing Policy. At Treasury I oversaw three programs focused on access to capital: the Small Business Lending Fund (SBLF), the State Small Business Credit Initiative (SSBCI), and the Community Development Financial Institutions (CDFI) Fund. I am currently a member of the Board of Directors of Small Business Majority, a national small business advocacy organization, and the Vice President and Director of ESG Research for Calvert Research and Management. I am appearing today as a private citizen and the views expressed here are my own and should not be attributed to any of the organizations I just mentioned.

Given my background, my testimony today focuses on the important role small businesses play in the innovation economy. Small businesses are the foundation of our communities and the largest single source of new job growth in our economy. Over the last two decades, small and new businesses have been responsible for creating 2 out of every 3 net new jobs.[1] Importantly, these jobs are often the high-quality, higher-paying jobs that provide pathways to the middle class. Fully half of our country's private sector workforce works for a small business.

Small businesses are also one of our country's greatest sources of innovation. All of our most successful innovators, from Apple to Amazon, started small. Their meteoric growth was not inhibited by regulation but could have been without access to capital needed to grow and scale their business.

In my testimony today, I wish to discuss three important points:

- Most small business owners believe some regulation is needed in a modern economy.
- Many small business owners rank access to capital as a bigger concern than regulation; and

- Smart policy can promote safe and affordable credit and encourage innovation.

Let me discuss these in turn.

Most small business owners believe some regulation is needed in a modern economy.

According to recent polling from Small Business Majority, 4 out of 5 small business owners agree that some regulation of business is needed for a modern economy.[2] While no one likes "red tape" and filling out paperwork, most Americans can appreciate that some regulation is needed to promote fairness and competition. Smart regulation ensures a level-playing field, promotes transparency, and encourages innovation through fair competition. Regulation, that over time, is applied unevenly between new market entrants and older competitors or unevenly between small and large businesses can have unintended consequences that distort a market.

That's why, according to the same Small Business Majority poll, more than three-fourths of small business owners disagree that we should get rid of all regulations on businesses and think that some regulations are important to protect small businesses from unfair competition and to level the playing field with big businesses. What's more, an overwhelming majority of 82 percent agree that their business can live with some regulation if it is fair, manageable and reasonable.[3]

Furthermore, the absence of regulation alone is not nearly enough to support innovation. Quite simply, in order to start, grow, and expand their businesses, entrepreneurs need capital. While our capital markets work well for most established, large- and mid-sized businesses, they are not suited for all businesses. For example, small, early-stage, rural, minority-owned, and women-owned businesses often struggle to find financing and consistently rank access to capital as a bigger concern than regulation.

Many small business owners rank access to capital as a bigger concern than regulation.

Access to financing is often one of the biggest hurdles small business owners face, particularly for the smaller loan amounts many new or very small businesses seek. Seventy-six percent of all businesses in the United States have average annual receipts of less than $100,000.[4] For minority-owned and woman-owned businesses, that figure is even higher: 86 percent of minority-owned businesses and 88 percent of woman-owned business bring in less than $100,000 per year.[5]

Importantly, business ownership is often a critical pathway to the middle class for minority and low income families. Recent research from the Center for American Progress, for example, found that business ownership is a critical component of wealth building for low-income families. African-American business owners have more than $52,000 in total wealth compared to just over $7,000 for non-business owners.[6] The same holds true for Hispanic business owning households, which have more than $41,000 in total wealth on average compared to $16,000 for

non-business owners.[7] Wealth building benefits both business owners and their communities. Greater savings helps families weather financial setbacks and move up the economic ladder, but it means these households spend more money boosting their local economy too.

Not surprisingly, most small businesses tend to seek small-sized loans. According to the 2016 Small Business Credit Survey, a national collaboration of the 12 Federal Reserve Banks, more than half of small businesses (55 percent) seek loans of $100,000 or less.[8] But while small loan amounts are the most sought after, they are also becoming the most difficult to obtain.

Historically, community banks (less than $10 billion in assets) were the bedrock source of relationship lending to businesses in their communities. Community bankers are often closest to their borrowers and in a unique position to assess and address the credit needs of their customer base. This can lead to more effective risk assessments and better outcomes for lenders and borrowers. But this type of high touch lending is also expensive — it costs about the same to underwrite a $5 million dollar loan as a $200,000 loan.[9] This decline in profitability has meant a widening small business credit gap even during an economic recovery.

A recent study by the Federal Reserve Bank of Chicago using flow of funds data showed just how dramatic the shift has been. From 1997 (long before the Great Recession) to 2015, community banks' share of originations less than $100,000 declined from 82 percent to 29 percent in less than 20 years.[10] It is estimated that this market share has been captured by larger banks (greater than $10 billion in assets), which steer small businesses with limited credit needs into business credit card products with higher revenue generation potential and a growing market of nonbank alternative lenders hoping to leverage advancements in technology and the proliferation of data about small businesses to lower the cost of extending credit.

As more small businesses utilize internet-based services for shipping, ordering, or record keeping; to make or accept digital payments; and to engage with social media they are creating large, real-time datasets about their businesses that can be applied to credit underwriting. These developments are encouraging many new companies, or in some cases established companies with no history of extending credit, to begin offering small business financing products often without the regulatory oversight and supervision applied to banks. While I was at Treasury we studied how these new financial technology companies were changing the landscape for small business financing.

In a white paper Treasury released in May 2016, one of our findings was that an uneven regulatory and supervisory regime creates risks for small business borrowers and that more robust small business borrower protections were needed.[11] These findings are supported by Small Business Majority polling which found 3 out of 4 small business owners felt that while online small business lending opened up new sources of capital and credit for small business owners, it should be regulated to ensure small business borrowers are protected from predatory practices. What's more, an overwhelming majority of 8 in 10 small business owners reported they were in favor of regulating online lenders to ensure interest rates and fees are clearly disclosed to borrowers.[12]

Since leaving my government service, I wrote a paper for the Progressive Policy Institute to describe how common-sense, low cost disclosures could help small business owners compare credit products and promote fair competition in the small dollar loan market.[13] Starting a business is risky enough, and getting a loan shouldn't be one of those risks.

Smart policy can promote safe and affordable credit and encourage innovation.

Smart policy can promote safe and affordable credit and encourage innovation at the same time. First, as the title of my PPI paper suggests, it's time to "shine a light" on the small business credit market and end buyer beware practices that, if left unchecked, can curb small business growth and job creation. Second, while transparency will make credit safer and more affordable, there will still be some businesses that will need help qualifying for a loan or accessing critical early-stage capital. For these businesses, particularly early-stage, rural, tribal, minority-owned, and women-owned businesses, targeted federal support can unlock private sector resources and help drive capital to underserved markets.

I would like to elaborate on each of these points in turn.

Promoting a Transparent Marketplace

Transparency is critical to promoting market competition, which should ultimately provide small business borrowers better products at better prices. But to ensure a market is fully transparent, disclosure requirements should apply equally to all small business financing products regardless of whether the provider is a bank, credit card, merchant cash advance, online marketplace lender, or any new companies yet to emerge.

To minimize the cost to finance providers of extending "truth in lending" disclosures to small business credit products, I recommend in my paper targeting them to small business loans or credit products of $100,000 or less where the use of proceeds is for business purposes. The $100,000 threshold allows policy makers to target protections to borrowers who are more likely to have very small businesses and to approach financial decisions as they would in their daily life as consumers. Importantly, since merchant cash advances and some working capital products offered by payments processors are not defined as loans, legislation would need to explicitly define this type of financing as a covered credit product.

When Small Business Majority polled my proposal after it was published, they found a decisive majority of 87 percent of small business owners support a "truth in lending" act for small business lending to ensure loan rates and terms are disclosed transparently and consistently.[14]

Encouraging Public-Private Partnerships to Unlock Capital for the Innovation Economy

Transparency will go a long way toward promoting better products at better prices for the majority of small businesses that seek smaller loan sizes, but to truly unlock innovation and

support growth, some entrepreneurs will need a little extra boost tapping the capital markets. I'd like to highlight one of the very successful and innovative public-private programs I had the privilege of working on during my time at Treasury as a model for federal support for innovation and entrepreneurship.

The State Small Business Credit Initiative (SSBCI) was funded with a one-time authorization of $1.5 billion through the Small Business Jobs Act of 2010. It was a new program and a true experiment borne of the need to jumpstart small business lending and investment during the financial crisis. The program worked by allowing states to set up their own small business support programs targeted to local economic needs. It was so flexible there were just two primary requirements: 1) states had to establish at least one from a list of five possible credit or equity programs; and 2) states had to provide a plan for leveraging $10 of new private sector small business financing for every $1 of SSBCI funds expended.

Unlike other federal programs, like those administered by the Small Business Administration for example, it was not a one-size-fits-all approach. Some communities chose to target micro-businesses while others targeted manufacturers or high-tech companies. Each state has its own needs and, with them, developed a unique set of partners to administer the programs. In total SSBCI funded 154 programs nationwide, over 80 of them new, and dedicated $1 billion to lending programs and over $400 million to venture capital programs targeting investment in early stage businesses.[15]

From 2011 through 2016 (the last year data was collected), SSBCI supported over $10.7 billion in new lending or investments and was estimated to have created or retained over 240,000 jobs. In total, SSBCI supported over $2.5 billion in financing for small manufacturers, $1.5 billion in financing for women or minority-owned small businesses, and $4 billion to early-stage businesses with high growth potential. Even more remarkable, with no federal requirement to do so, over 42 percent of SSBCI-supported loans or investments were made to businesses in low- and moderate-income (LMI) communities.[16]

I would like to share a couple of examples of how states took advantage of SSBCI's flexibility to target local market needs.

It is well documented that 75 percent of venture capital dollars in this country go to just three states: California, New York, and Massachusetts. New Mexico, which boasts strong research universities and three federal laboratories, saw SSBCI as an opportunity to attract venture capital to New Mexico to help with the commercialization of innovative technologies already being developed in the state. With $5 million from SSBCI, $10 million from the State Investment Council, and $5 million from private institutional investors, New Mexico created the Catalyst Fund to invest in seed and early-stage technology companies. Portfolio funds, which receive investment from the Catalyst Fund, must provide at least matching private investment, bringing the total investment to at least $40 million.

By contrast, California, which already has a robust venture capital market, chose to focus on credit support programs. One in particular, CalCAP, was a capital access program that partnered with community development financial institutions (CDFIs) to provide micro-loans in LMI communities. An example is Opportunity Fund, a CDFI based in San Jose and serving the Bay area. Through the end of 2017, Opportunity Fund extended more than 8,500 loans worth $142 million through CalCAP, which supported businesses as diverse as tamale makers to restaurants and grocery stores and helped commercial companies in many sectors and neighborhood service providers grow. According to Luz Urrutia, Opportunity Fund's CEO, "CalCAP has been key to our ability to finance thousands of California businesses. It enables us to take reasonable risk and to say 'yes' to more than 10 promising businesses every day. These businesses create jobs and local economic activity."[17]

These two examples illustrate the power of leverage — a little bit of federal support partnered with state and private sector resources — and the power of flexibility to drive innovation and inclusive economic growth. We need more smart policy like SSBCI, but sadly many of the 154 state programs SSBCI seeded will not survive without some continued federal support. The program expired in 2017 and I recommend to the Committee if you are considering policies to support innovation and small businesses, you should consider reauthorizing SSBCI in some form again.

Conclusion

The source of America's strength in the world is our vibrant economy. From Main Street shops to high-tech startups, small businesses are the backbone of our economy and are critical to supporting inclusive economic growth. They play an outsized role in providing the high-quality, higher-paying jobs that sustain America's middle class. To maintain our reputation as the best country in the world to start and scale a great company, we must continue to make smart investments in small businesses through programs like SSBCI and ensure that where regulations exist, they exist to level the playing field for free and fair competition – not just create red tape.

Endnotes

[1] Small Business Administration, "Frequently Asked Questions," June 2016.

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[3] Ibid.

[4] Consumer Financial Protection Bureau, "Key dimensions of the small business lending landscape," May 2017.

[5] Ibid.

[6] Center for American Progress, "A Progressive Agenda for Inclusive and Diverse Entrepreneurship," October 2016.

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[9] Goldman Sachs Equity Research, "The Future of Finance," March 3, 2015.

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[13] Milano, Jessica. "Shining a Light on Small Business Credit: Promoting a Transparent Marketplace," Progressive Policy Institute, November 2017.

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[15] US Department of the Treasury, "State Small Business Credit Initiative: A Summary of States' 2016 Annual Reports," July 24, 2017.

[16] Ibid.

[17] Seidman, Ellen, "Capital Access Programs: CDFI Case Study on the California Capital Access Program," Urban Institute, April 2018.