FINTECH INVESTIGATIVE REPORT

This report, compiled by the Office of Congressman Emanuel Cleaver, II, was released in August 2018.

BACKGROUND:

Last year, Congressman Cleaver launched a groundbreaking investigation into the small business lending practices of Financial Technology (FinTech) companies, studying the various methods companies use to protect against discriminatory practices. One of the primary concerns raised by Congressman Cleaver was the specific algorithms used by FinTech firms. While many FinTech firms claim these algorithms protect against discrimination, they have generally provided little evidence into how they are utilized to do so. The questions surrounding the algorithms are particularly troubling because, in some cases, they have the ability to utilize certain information about loan-seekers without their knowledge. Information collected can come from a wide range of sources, including the loan seeker's Twitter or Facebook profiles, specifically who they follow, and the number of criminal records and/or bankruptcies in the loan seeker's zip code. Not only is this information unrelated to the purposes of loan seeking, it can be used to discriminate against certain people, predominantly lower-income borrowers and people of color. The following report includes the detailed findings of Congressman Cleaver's investigation. Companies mentioned in this investigation are LendUp, Fora Financial, Biz2Credit, Kabbage, LendingClub, and OnDeck Capital, Inc. It should be noted that LendUp is in fact a consumer lending company, but they have graciously agreed to participate in this investigation.

INITIAL FINDINGS:

1

FinTech loans are more likely to be used by minority owned companies

2

More action is needed in order to limit unfair business practices

3

Some participants have implimented practices that should be widely adopted

INITIAL FINDINGS (Cont.)

The first finding emphasizes the importance of this investigation. Data reviewed from the responses predominately demonstrates that the loans these companies provide are more likely to be utilized by minority owned businesses. It is important to ensure that these products are providing the opportunities they promised to these businesses and are not exploiting historically disadvantaged groups.

Though a number of these businesses have mentioned their success at "disrupting" the banking industry, it is important that policymakers ensure that FinTech lenders do not replicate retrograde and unfair practices of traditional lenders. For example, almost every company that disclosed a reasonable amount of information admitted to using forced arbitration clauses in their contracts. These clauses require individuals to resolve all disputes out of court in a situation that is more favorable to the lenders, both from a monetary and public relations perspective. Also, several companies stated that they used personal credit scores in determining small business loans. This is a common practice at traditional banks, but can be exploitative and is largely unnecessary. A personal credit score has little bearing on a business model or the owner's business acumen, and using it unfairly punishes minority business owners who may not have had the same opportunities to build credit. What is more unsettling, perhaps, is how little we know about how these personal credit scores factor into the underwriting process, or whether they are even used. One of the most concerning findings was how willfully vague some companies were being about the structure and nature of their algorithms. While a few companies provided detailed information, others did not disclose whether they used race and gender information, or proxies for it, in their loan calculations. This lack of volunteered information is concerning given the limited oversight our government currently has over the use and compiling of these algorithms. Without this information, we are unable to identify potentially discriminatory practices. Some companies, however, have stepped up and implemented rigorous examination processes for their algorithms, including an objective third party review.

FinTech lending services provide a unique opportunity to allow historically underserved communities to start small businesses and participate in "The American Dream"

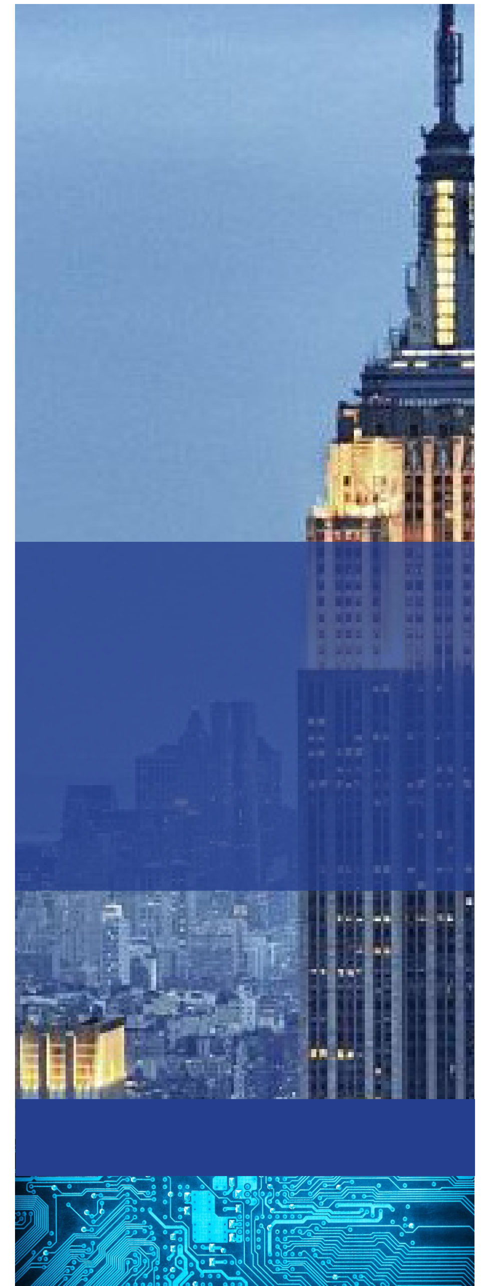
These findings and the issues addressed hereafter are not intended to suggest that FinTech does not have the potential to be an equalizer in the lending market, because it does. The potential exists because FinTech lending services provide a unique opportunity to allow historically underserved communities to start small businesses and participate in "the American dream". However, as with other industries, Congress must ensure that those who are already at a historic or economic disadvantage aren't being unfairly targeted by the proliferating financial sector. FinTech lending is a fast-growing industry offering a new wave of innovation, but, just like in any "wild west" new business environment, there are potential risks. Listed below are common practices and Congressman Cleaver's recommendations to help prevent potentially discriminatory practices in this space.

EXAMPLES OF GOOD AND BAD PRACTICES

Based upon the findings of this investigation, Congressman Cleaver has highlighted some beneficial measures that companies have taken to prevent discrimination, while also noting some potentially hazardous practices. Of the several companies that reported back, several companies admitted to extracting a customer's credit report. As stated previously, this action could easily identify the customer's race, gender, etc. making them more vulnerable to discrimination. Moreover, in some cases, certain contract clauses forbid the borrower to take the lender to court. These two practices are the most potentially discriminatory procedures disclosed by the companies. In contrast, FinTech companies have also reported the mechanics of their systems which they hope could prevent discriminatory behavior. One company created an alternative to reviewing a business owner's personal credit score by creating what they call a "proprietary credit score" meant to predict the future performance of the company by studying their previous credit history and cash flow. Furthermore, all of the companies Congressman Cleaver reached out to made assurances that they do not factor race, gender, or other personal details into the underwriting process. As previously stated, some companies also include a third party in the lending process to protect from engaging in unintentional discriminatory behavior. From the responses gathered, it has become increasingly clear that a majority of the companies have taken some measure to prevent blatant discrimination, nevertheless, additional protections are very much needed.

BAD PRACTICES

Looking at the initial findings, a few negative practices were evident, but by far the most ubiquitous issue was what the reports didn't say. Some reports lacked key information or were willfully vague. This lack of information makes it difficult to evaluate these companies, resulting in an incomplete and unsatisfactory picture of their protections against exploitation. If companies cannot volunteer even the most limited information, how can they be trusted to provide fair credit to small business owners?



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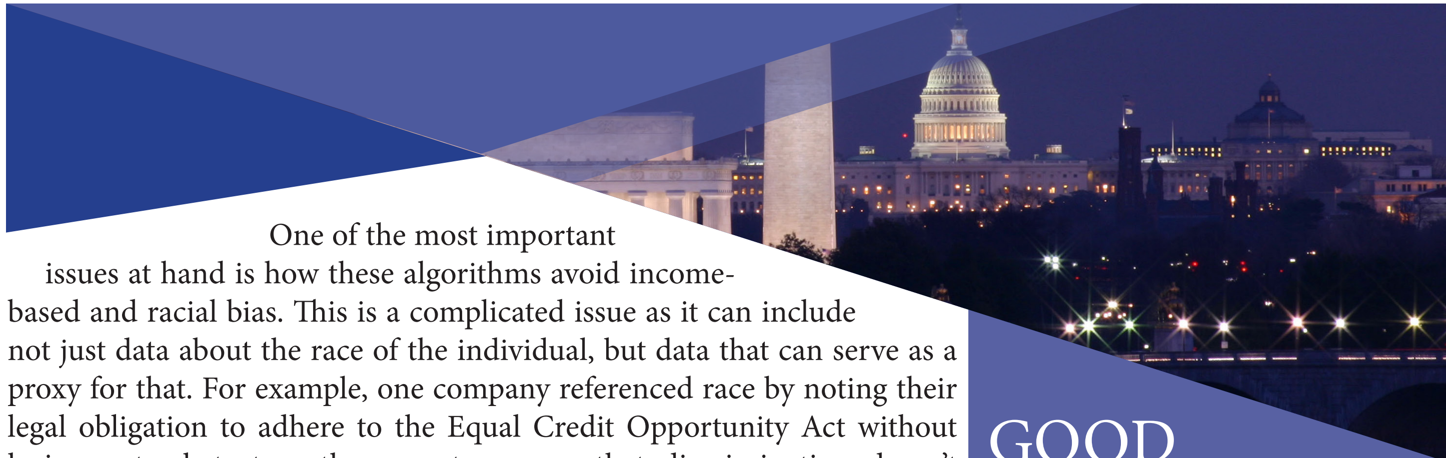

One of the most important issues at hand is how these algorithms avoid income-based and racial bias. This is a complicated issue as it can include not just data about the race of the individual, but data that can serve as a proxy for that. For example, one company referenced race by noting their legal obligation to adhere to the Equal Credit Opportunity Act without laying out what steps they use to ensure that discrimination doesn't happen. The issue is not whether laws still apply to these companies - the issue is what they are doing to ensure these laws are being followed.

Additionally, there were several issues that are similar to the practices of traditional banks. Several of the companies mentioned using forced arbitration practices to resolve disputes with small businesses and individuals. Forced arbitration practices are almost universally advantageous to companies, as the individuals are not well protected, and the proceedings happen behind closed doors, allowing the company to avoid potentially negative press coverage. If these companies have faith in their algorithms, they should find forced arbitration unnecessary.

Finally, several companies mentioned using credit scores, but were vague on the methods in which they were used. Further, some of the companies that provided specific responses contained worrisome practices. For example, one company makes explicit use of personal credit scores in order to determine a business's credit worthiness. This is not useful in determining a business's creditworthiness as the business is not the person, and can often be discriminatory to those who have not had the same opportunities to generate credit. One company mentions that the more data available on the business, the less they need credit scores; however, this still puts many newfound businesses at a significant disadvantage.

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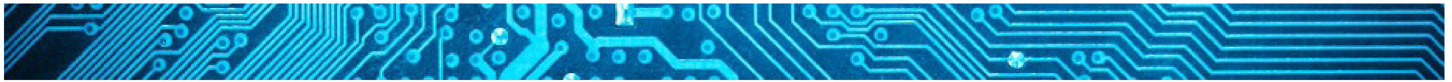
GOOD PRACTICES

Out of the several companies contacted, two in particular responded with detailed examples of the measures they take to protect against discrimination. Both companies explained that they comply with the Equal Credit Opportunity Act and work in accordance with those rules. Furthermore, they claim to not factor or record race, sexuality, gender, etc. in the underwriting process. They also laid out specific ways that they protect against these discriminatory practice.

As previously mentioned, one company stated that they do not utilize a recipient's personal credit score. Rather, they have developed a proprietary credit score to predict future credit performance and factor in the financial performance of the company rather than personal details on the loan recipient. Another company has admitted to collecting a recipient's credit report with previous consent,



but claims to only utilize the credit report for their "anti-money laundering, know your customer" verification process. These companies also aim to separate the company from the person by assessing the company's potential. One company also recognizes the risk of utilizing algorithms, thus, they advocate for external or third-party validation to ensure that the algorithms are not insinuating discrimination.

Lastly, another company cited their support for fair lending practices by incorporating an "external fair lending counsel and an economic consulting firm that are both recognized as national experts in fair lending," which, assess their potential risks. The results concluded that this company involved very little discretion in their lending decisions, "which is important because discretion can potentially lead to disparate outcomes for similarly-situated people."

RECOMMENDATIONS

While FinTech lending has its challenges, it can be potentially advantageous for small businesses looking to get a leg up in a competitive market. FinTech companies often serve markets that many traditional banks ignore, and they can deliver funds quickly, often on the next day. They are undoubtedly a valuable asset for small businesses, but business lending does not face the same scrutiny and regulations as consumer lending and that can create serious problems. Below are some recommendations that can help make FinTech lending a more trusted proces.

BE HONEST & TRANSPARENT

Securing a normal loan from a traditional brick and mortar bank is generally pretty straight forward. A borrower requests a certain amount of money, and secures the loan with interest payments and collateral. As a result of the Truth in Lending Act, these steps are all clearly set out. In the "wild west" of FinTech lending, this is not always the case. The interest rates can vary wildly, based on an unknown algorithm. There are new and untested products, such as merchant cash advances, which take a portion of future credit card receivables. It is important for this information to be clear for businesses so they know what they are applying for. As there is not adequate oversight over this new and growing sector, it is important for these companies to lead the charge. To that point, some services have a disclosure policy similar to that of traditional banks where the information is laid out clearly and concisely for the lender. We recommend that all FinTech companies follow through on this policy in order to ensure transparent dealings with American small businesses.

BE FAIR

While a credit score can be useful in determining an individual's creditworthiness, it matters very little in the world of business loans. A business's ability to repay credit is not based on the owner's credit history, but the quality of their business model, and a history of success. Further, if a business fails, attaching a personal credit score to a loan that they cannot pay back unfairly punishes the small business owner for the rest of their life. Using credit scores is also unfair to disadvantaged communities, who often don't have the same opportunities to build credit. It is recommended that FinTech companies discontinue the outdated practice of using personal credit scores.

BE ACCOUNTABLE

Enterprise and progress are at the heart of the American ideal, and this is clearly evident as FinTech companies disrupt the banking industry. While profits are essential to any company, profits cannot be allowed to take precedence over the protection of consumers. To ensure that does not occur, companies must be willing to hold themselves accountable. In the new world of FinTech lending, this requires examining the algorithms used to determine creditworthiness. Mandatory third party objective evaluation is recommended. This serves as an important step in improving a company's algorithm. Even the smartest people miss things that are right in front of them, and when the success or failure of a person's livelihood can hinge on these algorithms, it is essential that everything possible is being done to guarantee nothing is missed. A third party can look at the bigger picture and catch minute details that others may not, such as proxies for race or gender, or something that might unfairly disadvantage particular populations. This also sends a message that your company is honest and willfully transparent.

An honest company should be willing to prove themselves in front of the public eye, and hold themselves accountable when mistakes are made. Forced arbitration is the opposite of this. It puts matters behind closed doors and puts the borrower at a disadvantage. If a company is confident in the quality of its product, then it should be willing to prove that openly and not in some backroom. Removing forced arbitration is another recommendation to promote accountability.

CLEAVER PRINCIPLES FOR FINTECH LENDING

BE HONEST AND TRANSPARENT

Small businesses want partners they can trust. Lenders must embrace full transparency about the costs and risks of their products.

• Responsible fintech lenders should seek to replicate Truth-in-Lending Act disclosures for borrowers.

BE ACCOUNTABLE

A good business is not afraid of the public eye, and is willing to right any wrongs, putting its customers first.

• Fintech lenders should register with the Consumer Financial Protection Bureau's complaint system to receive and respond to complaints. Lenders should also inform borrowers about how to file a complaint in all communications.

• While resolving disputes through arbitration can sometimes be in the interests of both the lender and the borrower, lenders should not force borrowers into resolving their dispute through arbitration to evade accountability.

BE FAIR

Fintech lenders may be unknowingly reinforcing discriminatory practices through machine-learning and algorithmic bias. It is critical to combat this discrimination using appropriate policies and procedures.

• Conduct – and make publicly available – third-party fair lending audits that analyze loan origination data to determine whether there are statistically significant discriminatory markups.

• When potentially discriminatory mispricing is found, immediately offer rate reductions and account credits to correct deficiencies.

BE INCLUSIVE

While fintech lenders disproportionately originate loans to communities of color, lenders are struggling with issues of diversity and inclusion when it comes to their own management and senior leadership.

• Managers, staff, and directors should closely reflect the communities lenders are serving. Human resources practitioners should prioritize diversity in its human capital strategy.

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