
NOTE

USING A CDFI-LIKE PROGRAM TO EXPAND
ONLINE LENDING TO MINORITY
BUSINESS OWNERS

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Minority business owners face challenges in accessing credit due to banking industry-wide trends moving away from small-dollar loans and because many have less formal credit information. Online lenders have emerged to meet this market demand, using various sources of data besides credit scores to assess creditworthiness. These platforms help minority business owners who have limited credit data. However, online lenders may suffer liquidity problems during a recession, when business owners may be especially in need of funding.

This Note advocates for programs that incentivize online lenders to invest in low-income and minority communities. Specifically, this Note outlines a proposal for a community development financial institution fund-like subsidy system that offers federal grants to online lenders that invest in certain low-income communities and businesses, upon the condition that these lenders will maintain enough capital reserves to ensure they can continue providing credit during a recession. Such a program can help ensure minority business owners have consistent access to credit.

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I. INTRODUCTION

Minority business owners are less likely to be approved for or even apply for a loan from a large bank. Many are considered risky to lend to because they have less credit information and operate in communities that are heavily impacted by economic downturns. In the last few decades, as banks have focused their businesses toward making large, higher-profit loans, a gap in the market for small-dollar loans has emerged—the type of loans that small businesses usually seek. Online lenders have emerged to meet this market demand. While large banks often rely on traditional measures of credit, online lenders use various sources of data to assess creditworthiness, helping facilitate loans where there is information asymmetry.

However, owing to their business model, online lenders may suffer liquidity problems during an economic recession, potentially leaving their borrowers without a consistent source of credit. Imposing capital and liquidity requirements could help ensure that online lenders have the capital reserves to stay afloat during a recession; however, a balance should be

maintained between regulation and allowing online lenders to maintain their dynamic business model.

This Note focuses on online lenders that provide small business loans. It examines how online lending affects minority entrepreneurs, who often face additional challenges stemming from lower wealth and financial instability in their communities—the result of historical discrimination that credit and banking reforms have thus far failed to adequately remedy.

This Note argues that online lenders have the potential to facilitate lending at fairer interest rates where there is information asymmetry, which would help minority business owners access credit. However, these forms of credit may disappear during a recession when business owners most need funding. Part II describes the lending landscape today and the limited borrowing opportunities for minority business owners, who often have lower levels of assets and wealth. Part III explains how online lenders fill a gap in the credit market for small business loans by escaping the stricter requirements of bank regulation. Part IV advocates for programs that incentivize online lenders to invest in low-income and minority communities. Specifically, Part IV outlines a proposal for a subsidy similar to that of community development financial institutions (CDFIs) that would offer federal grants to online lenders that invest in certain low-income communities and businesses, upon the condition that these lenders maintain enough capital reserves to ensure they can continue providing credit during a recession.

II. CHALLENGES FOR MINORITY BUSINESS OWNERS IN ACCESSING AFFORDABLE CREDIT

This Part outlines the change in banks' business models that has led to a decline in small-dollar lending. In addition, this Part describes the additional barriers minority business owners face in accessing credit and the impact this lack of access to credit has had on their communities.

Section A describes banks' business model today, which prioritizes large-dollar loans and leaves many small-business borrowers without options for bank funding. Section B

describes the specific obstacles minority business owners face in obtaining loans and the ineffectiveness of federal programs in addressing this need.

A. Banks Today Tend To Focus on Higher-Profit Loans and Use Standardized Underwriting Criteria

Historically, community banks played an important role in providing loans to people in the community. Community banks are typically small banks that serve a limited geographic area.¹ Community bank officers recognized people in the community and could underwrite loans based on soft factors, such as reputation.² In the late 1900s however, large banks began rapidly acquiring smaller banks and converting them into branches of the parent bank.³ Because of the fixed cost of underwriting a loan, larger banks tend to focus on larger, higher-profit loans.⁴ Most large banks have a minimum loan amount.⁵

As a result, a gap in access to bank funding opened up, especially for “small dollar loans” of less than \$250,000—the

¹ DANIEL BROWN, U.S. SMALL BUS. ADMIN., SPOTLIGHT ON COMMUNITY BANKING (2019), <https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/25164013/Fact-Sheet-Community-Bank-Lending.pdf> [<https://perma.cc/B9XH-Y6EN>].

² MEHRSA BARADARAN, HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY 149 (2015).

³ Jeremy C. Kress & Matthew C. Turk, *Too Many To Fail: Against Community Bank Deregulation*, 115 NW. UNIV. L. REV. 647, 678 (2020) (noting that the decline in micro-community banks was mainly due to the bank acquisitions that followed legal reforms, such as the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994).

⁴ FINREG LAB, THE USE OF CASH-FLOW DATA IN UNDERWRITING CREDIT: SMALL BUSINESS SPOTLIGHT 6 (2019), <https://finreglab.org/wp-content/uploads/2019/09/FinRegLab-Small-Business-Spotlight-Report.pdf> [<https://perma.cc/BZU9-9SRQ>] (detailing how underwriting loans can be an expensive process and tend to cost the same regardless of the size of the loan).

⁵ FED. DEPOSIT INS. CORP., FDIC SMALL BUSINESS LENDING SURVEY 44 (2018), <https://www.fdic.gov/bank/historical/sbls/full-survey.pdf> [<https://perma.cc/DDM4-NZXS>]. While 69.8% of large banks have a minimum loan amount when lending to small businesses, a much smaller percentage, 14.8%, of small banks have such a requirement. *Id.*

amounts that small businesses typically request.⁶ Small businesses often turn to banks when seeking external financing.⁷ Thus, with the decline in bank-funded small-dollar loans, small businesses lose a major avenue for obtaining funding.

Furthermore, large banks often rely on standardized qualitative criteria to assess loan applications, which often disqualifies small business owners with limited credit data from eligibility.⁸ Large banks rely on business credit scores to a far greater extent than small banks: More than sixty-four percent of large banks almost always evaluate business credit score in their underwriting criteria, while only roughly fifteen percent of small banks do the same.⁹ In contrast, because of their connection to local communities, small banks engage in “relationship lending” and are more willing to offer loans to customers who lack the credit histories required by larger banks.¹⁰ Smaller banks’ flexibility in lending criteria allows entrepreneurs with limited credit history opportunities to secure a bank loan. However, racial prejudice may still play into loan officers’ decision,¹¹ affecting minority business owners’ ability to take advantage of “relationship lending.”

⁶ Karen Gordon Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation* 42 (Harv. Bus. Sch., Working Paper No. 17-042, 2016). In 2020, seventy-eight percent of small business sought loans of under \$250,000. FED. RSRV. BANKS, 2020 REPORT ON EMPLOYER FIRMS: SMALL BUSINESS CREDIT SURVEY 10 (2020), <https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2020/2020-sbcs-employer-firms-report> [<https://perma.cc/7GNT-Y9CV>].

⁷ Forty-four percent of small businesses used a bank in the last five years, compared to twenty percent that used online lenders and six percent that used credit unions. FED. RSRV. BANKS, *supra* note 6, at 9. Furthermore, forty percent of small business credit applicants applied to large banks while thirty-six percent applied to small banks; applicants sought credit from banks more than from other sources. *Id.* at 15.

⁸ FED. DEPOSIT INS. CORP., *supra* note 5, at 40.

⁹ *Id.*

¹⁰ Mills & McCarthy, *supra* note 6, at 28.

¹¹ See, e.g., Lynnise E. Pantin, *The Wealth Gap and the Racial Disparities in the Startup Ecosystem*, 62 ST. LOUIS UNIV. L.J. 419, 440 (2018) (summarizing a study that found Black and Latino business owners were

Collateral requirements pose another obstacle for small business borrowers. Small banks are more likely to accept collateral in commercial or personal real estate as compared to large banks.¹² Some small businesses are nevertheless unable to meet those collateral requirements and turn to online lenders to fulfill their financing needs. Thirty-nine percent of small businesses applying to online lenders for credit cited the lack of collateral requirement as one of their reasons for seeking out that lender.¹³

Bank loans to small businesses further dropped after the 2008 financial crisis. After 2008, loan origination for the four largest U.S. banks dropped by fifty percent and had not recovered by 2015.¹⁴ The dollar volume of small business loans remained steady from 2017 to 2018,¹⁵ then sharply increased during the pandemic as Payment Protection Program (PPP)¹⁶

provided less information about loan terms, offered less application help by loan officers, and were less frequently handed a business card).

¹² FED. DEPOSIT INS. CORP., *supra* note 5, at 41. Though large banks are three times likelier than small banks to accept no collateral for a loan, this can be attributed to the fact that large banks are likelier to lend to larger, more mature firms with established credit records, thus reducing the bank's need to use collateral to mitigate risk. *Id.*

¹³ FED. RSRV. BANKS, *supra* note 6, at 16. By contrast, fifteen percent of small business applicants to large banks, and thirteen percent of small business applicants to small banks, cited the lack of collateral requirement as their reason for applying to those respective lenders. *Id.*

¹⁴ FINREG LAB, *supra* note 4, at 8.

¹⁵ Charles Morris & Kristen Regehr, *Small Business Lending Conditions Are Stable, But Terms Show Some Tightening*, FED. RSRV. BANK OF KAN. CITY (June 19, 2018), <https://www.kansascityfed.org/surveys/small-business-lending-survey/2018q1-small-business-lending-survey/> [<https://perma.cc/2T42-3BT9>].

¹⁶ The Paycheck Protection Program (PPP) was a federal program offering forgivable loans to small businesses during the COVID-19 pandemic. The loan amounts were forgiven if the recipient used the funding for payroll, mortgage interest, rent, or utility costs over the eight-week period following loan disbursement and if the recipient maintained pre-pandemic employee and compensation levels. *Paycheck Protection Program (PPP) Information Sheet: Borrowers*, U.S. TREASURY, <https://home.treasury.gov/system/files/136/PPP—Fact-Sheet.pdf> [<https://perma.cc/972E-H4DD>] (last visited Feb. 28, 2022).

loans were administered.¹⁷ Excluding PPP loan origination, new small business lending increased approximately thirty-eight percent from 2020 to 2021.¹⁸ Credit underwriting standards for small businesses by banks tightened in the years following the 2008 financial crisis and remained largely unchanged until 2018.¹⁹ Credit standards tightened in 2020 and 2021.²⁰

B. Minority Entrepreneurs Face Additional Barriers in Obtaining Loans

While small business owners in general face greater difficulties in accessing credit from banks, minority business owners often face additional challenges. Minorities often have lower levels of asset and wealth along with limited credit information than non-minorities.²¹ Many banks have left low-

¹⁷ Thomas Hobson, *Loans Secured by Small Business Administration Guarantees Drive Large Increases in New Small Business C&I Lending*, FED. RSRV. BANK OF KAN. CITY (Sept. 29, 2020), <https://www.kansascityfed.org/surveys/small-business-lending-survey/2020q3-loans-secured-by-small-business-administration-guarantees-drive-large-increases/> [https://perma.cc/KL6X-ZMA2].

¹⁸ Dustyn DeSpain & Thomas Hobson, *Small Business Lending Normalizes in the Fourth Quarter*, FED. RSRV. BANK OF KAN. CITY (Mar. 29, 2022), <https://www.kansascityfed.org/surveys/small-business-lending-survey/small-business-lending-normalizes-in-the-fourth-quarter/> [https://perma.cc/V58Z-BUMU].

¹⁹ OFF. OF THE COMPTROLLER OF CURRENCY, 2016 SURVEY OF CREDIT UNDERWRITING PRACTICES 10 tbl.10 (2016), <https://www.occ.gov/publications-and-resources/publications/survey-of-credit-underwriting-practices/files/pub-survey-cred-under-2016.pdf> [https://perma.cc/DYC5-CM9A] (showing that over 60% of banks tightened their small business credit underwriting criteria in 2009 and 2010 and around 80% of banks' criteria has remain unchanged since 2012). The OCC Survey assessed the underwriting practices of 93% banks representing 92% of the total assets and 90% of gross loans in the federal banking system. *Id.* at 1; see also Morris & Regehr, *supra* note 15 (showing credit standards remain unchanged from 2017 to 2018).

²⁰ Hobson, *supra* note 17 (showing credit standards tightened in 2020); DeSpain & Hobson, *supra* note 18 (showing credit standards tightened in 2021).

²¹ See *infra* notes 25–28 and accompanying text.

income communities that have high minority populations, leaving the residents in these neighborhoods unbanked.²² Banks that do serve these communities are less profitable and more exposed to risk during economic downturns. Black entrepreneurs in particular face greater challenges in accessing credit because of government policy that segregated Black communities from the mainstream economy.²³ Reforms to address these challenges, such as the Community Development Financial Institution Fund (“CDFI Fund”) and the Community Reinvestment Act (CRA) have had limited success closing the gap in access to credit for low-income minority borrowers.²⁴ As a result, minority entrepreneurs continue to face greater challenges accessing credit.

1. Minority Entrepreneurs Often Have Lower Levels of Assets and Wealth, Leading to an Information Asymmetry

Minority entrepreneurs face additional obstacles in obtaining loans as many lack the credit data used by large banks to underwrite loans. Racial minorities and recent immigrants are less likely to have sufficient credit history to have a personal credit score, and those who do tend to have lower scores.²⁵ In addition, due to a history of redlining and segregation,²⁶ the wealth gap between white and Black families remains wide.²⁷ With less wealth, Black borrowers

²² See *infra* notes 28–32 and accompanying text.

²³ See *infra* Section II.A.ii.

²⁴ See *infra* Section II.A.iii.

²⁵ FINREG LAB, *supra* note 4, at 9.

²⁶ See MEHRSA BARADARAN, THE COLOR OF MONEY: BLACK BANKS AND THE RACIAL WEALTH GAP 107–08 (2017) (explaining how Fair Housing Act policies encouraged banks, homeowners, and realtors to enforce segregation).

²⁷ The average household net worth of a Black family in the United States is \$15,000 to \$25,000, while the average household net worth of a white family is \$115,000 to \$200,000. CITI GPS: GLOB. PERSPECTIVES & SOLUTIONS, CLOSING THE RACIAL INEQUALITY GAPS: THE ECONOMIC COST OF BLACK INEQUALITY IN THE U.S. 34 (2020), <https://eacnny.com/wp->

have less financial and non-financial assets that can serve as collateral, inhibiting their ability to access credit.²⁸

Furthermore, those in minority communities are more likely to be unbanked. Forty-four percent of Black households and forty-three percent of Hispanic households reported being unbanked or underbanked, while seventeen percent of white households reported the same.²⁹ From 2008 to 2013, banks shut down 2000 branches, ninety-three percent of which were located in postal codes where the household income was below the national median.³⁰ Community banks are rapidly disappearing from urban areas,³¹ where many minority communities are located.³² Because of this limited access to banks, many unbanked individuals turn to alternative financial lenders for financing.³³

2. Minority Business Owners Tend To Suffer Greater Economic Losses During Economic Recessions

Businesses operating in minority communities are more vulnerable than their counterparts during an economic

content/uploads/2020/11/Citi-Closing-Racial-Inequality-Gaps-AX2QY.pdf [https://perma.cc/6WRY-9LCX].

²⁸ *Id.* at 49.

²⁹ *Id.* at 55 fig.93.

³⁰ Frank Bass & Dakin Campbell, *Predator Targets Hit as Banks Shut Branches amid Profits*, BLOOMBERG (May 2, 2013, 12:00 PM), <https://www.bloomberg.com/news/articles/2013-05-02/post-crash-branch-closings-hit-hardest-in-poor-u-s-areas> (on file with Columbia Business Law Review).

³¹ BARADARAN, *supra* note 2, at 152.

³² Econ. Rsch. Serv., U.S. Dep't of Agriculture, *Racial and Ethnic Minorities Made up 22 Percent of the Rural Population in 2018, Compared to 43 Percent in Urban Areas*, Econ. Rsch. Serv., U.S. Dep't of Agriculture (Oct. 13, 2020), <https://www.ers.usda.gov/data-products/chart-gallery/gallery/chart-detail/?chartId=99538> [https://perma.cc/M6XG-CCVF].

³³ CITI GPS: GLOB. PERSPECTIVES & SOLUTIONS, *supra* note 27, at 55 fig.94 (demonstrating an inverse relationship between credit score and use of an alternative financial service).

downturn.³⁴ As will be shown, minority-owned businesses may not receive government assistance as readily as white-owned businesses, which tend to have better banking relationships or operate in neighborhoods that are less impacted by an economic downturn.

During the COVID-19 pandemic, banks often prioritized their own customers when they started administering PPP loans to small businesses.³⁵ Minority business owners are less likely to receive bank loans,³⁶ and thus they were often shut

³⁴ A New York Federal Reserve study found that 40% of the revenue from Black-owned businesses is concentrated in 30 counties, comprising 1% of all the counties in the United States. Two-thirds of these counties had the highest level of COVID-19 cases. Martin Crutsinger, *New York Fed: Black-Owned Business Hard Hit by Pandemic*, ASSOCIATED PRESS (Aug. 4, 2020), <https://apnews.com/article/virus-outbreak-health-new-york-business-u-s-news-ef407b45061d34503fa7413529b3fe04> [<https://perma.cc/D6TF-YHAJ>]. As of April 2020, due to the COVID-19 pandemic, the number of Black business owners dropped by 41%, Latino business owners fell by 32%, and Asian business owners fell by 26%. White business owners fell by 17%. CLAIRE KRAMER MILLS & JESSICA BATTISTO, FED. RSRV. BANK OF N.Y., DOUBLE JEOPARDY: COVID-19'S CONCENTRATED HEALTH AND WEALTH EFFECTS IN BLACK COMMUNITIES 1 (2020), https://www.newyorkfed.org/medialibrary/media/smallbusiness/DoubleJeopardy_COVID19andBlackOwnedBusinesses [<https://perma.cc/GBR8-NPYF>]; see also Ron Jarmin, C.J. Krizan & Adela Luque, *Owner Characteristics and Firm Performance During the Great Recession* 13 (Ctr. for Econ. Stud., Working Paper 14-36, 2014), <https://www2.census.gov/ces/wp/2014/CES-WP-14-36.pdf> [<https://perma.cc/265U-6TK4>] (finding that Black-owned businesses underperformed white-owned business during the Great Recession).

³⁵ Ruth Simon & Peter Rudegeair, *Big Banks Favor Certain Customers in \$350 Billion Small-Business Loan Program*, WALL ST. J. (Apr. 6, 2020, 8:00 AM), <https://www.wsj.com/articles/big-banks-favor-certain-customers-in-350-billion-small-business-loan-program-11586174401> (on file with the Columbia Business Law Review).

³⁶ A 2016 study by the Stanford Institute for Economic Policy Research found that one percent of Black business owners received a bank loan in their first year of business, compared with seven percent of white business owners. Twice as many white business owners used a business credit card during their first year as Black business owners. Emily Flitter, *Black-Owned Businesses Could Face Hurdles in Federal Aid Program*, N.Y. TIMES (June 4, 2020), <https://www.nytimes.com/2020/04/10/business/minority-business-coronavirus-loans.html> [<https://perma.cc/UP6G-L47N>].

out of early PPP funding.³⁷ CDFIs, which were established to serve low-income and disadvantaged communities,³⁸ could not bridge this gap. Only seventy-eight CDFIs had authorization to participate in the PPP in early April 2020; the rest had not received prior approval to make SBA loans.³⁹

In the first phase of PPP, seventy-five percent of loans went to businesses in majority-white census tracts, while only sixty-eight percent of the population lives in these census tracts.⁴⁰ In addition to there being a racially disparate impact, one study found that banks directly discriminated against applicants based on race.⁴¹ In a study where a Black borrower and white borrower with similar credit and asset characteristics went to the branches of seventeen banks seeking PPP loans, the Black borrowers were treated significantly worse than the white borrowers and were offered inferior products.⁴²

Moreover, early PPP funding was not available to sole proprietorships, a popular minority-owned business entity type:⁴³ Seventy percent of businesses with no employees are owned by women and minorities, compared to forty percent of

³⁷ See, e.g., ALVARO SANCHEZ ET AL., FED. RSRV. BANK OF PHILA., SMALL BUSINESS CREDIT SURVEY: COVID-19 AND DISPARATE FIRM CONDITIONS IN NEW JERSEY 9 (2021), <https://www.philadelphiafed.org/-/media/frbp/assets/community-development/reports/110321-sbcs-nj-report-final.pdf> [<https://perma.cc/BTD7-ZF7Q>] (detailing how minority-owned businesses received less of the requested PPP funds than white-owned businesses).

³⁸ See *infra* Section II.B.iii for discussion of CDFIs.

³⁹ Flitter, *supra* note 36.

⁴⁰ Emily Flitter, *Black Business Owners Had a Harder Time Getting Federal Aid, a Study Finds*, N.Y. TIMES (Jul. 15, 2020), <https://www.nytimes.com/2020/07/15/business/paycheck-protection-program-bias.html> [<https://perma.cc/8FRF-9Q4E>].

⁴¹ *Id.*

⁴² *Id.*

⁴³ Stacy Cowley, *Minority Entrepreneurs Struggled To Get Small-Business Relief Loans*, N.Y. TIMES (Apr. 4, 2021), <https://www.nytimes.com/2021/04/04/business/ppp-loans-minority-businesses.html> [<https://perma.cc/F2VG-GPEF>].

businesses with employees.⁴⁴ When sole proprietorships gained access to PPP funding, they were only eligible to receive loans if their business was profitable, a requirement to which other businesses were not subjected.⁴⁵ This profitability requirement was eventually revised in March 2021, but banks struggled to implement the revision.⁴⁶ JPMorgan Chase initially stated that it did not have time to update its systems to incorporate the changes before the PPP funding deadline,⁴⁷ but changed course after Congress extended the PPP deadline.⁴⁸ Bank of America stopped accepting applications early to give the bank time to manually sort out sole proprietorship applications.⁴⁹

One study also found that New Jersey minority-owned businesses were less likely to receive fully-requested government PPP funds than white-owned businesses.⁵⁰ While seventy-six percent of white-owned business reported receiving fully-requested PPP funds, only forty-four percent of

⁴⁴ Business Loan Program Temporary Changes; Paycheck Protection Program—Revisions to Loan Amount Calculation and Eligibility, 86 Fed. Reg. 13,149, 13,150 (Mar. 8, 2021) (to be codified at 13 C.F.R. pt. 120).

⁴⁵ Stacy Cowley, *supra* note 43.

⁴⁶ The Small Business Association issued a rule allowing sole proprietorships to use gross income, instead of net income, in their PPP eligibility calculation—thus allowing unprofitable sole proprietorships to be eligible for PPP funding. Business Loan Program Temporary Changes; Paycheck Protection Program—Revisions to Loan Amount Calculation and Eligibility, 86 Fed. Reg. at 13,150.

⁴⁷ Stacy Cowley & Jim Tankersley, *Biden Highlights Small-Business Help, as Problems Persist with Lending Program*, N.Y. TIMES (May 10, 2021), <https://www.nytimes.com/2021/03/16/business/economy/biden-paycheck-protection-program.html> [<https://perma.cc/A26E-J3M2>].

⁴⁸ Carmen Reinicke, *Small Businesses Have 2 More Months To Apply for Forgivable PPP Loans. Here's What You Need To Know*, CNBC (Mar. 26, 2021, 1:53 PM), <https://www.cnbc.com/2021/03/26/small-businesses-have-2-more-months-to-apply-for-forgivable-ppp-loans.html> [<https://perma.cc/8NBT-BT8Z>].

⁴⁹ Stacy Cowley, *Looming Deadlines and Last-Minute Changes Hinder P.P.P. Loans*, N.Y. TIMES (Mar. 16, 2021), <https://www.nytimes.com/2021/03/09/business/ppp-small-business-deadline.html> [<https://perma.cc/CSA5-7GLU>].

⁵⁰ SANCHEZ ET AL., FED. RSRV. BANK OF PHILA., *supra* note 37, at 9.

Black-owned businesses, and fifty-six percent of Asian-owned businesses received the same.⁵¹ Twenty percent of Hispanic-owned firms received none of the PPP funds they requested, compared to the overall firm average of three percent that received no PPP funds.⁵² Without a structure in place to ensure all business owners have access to emergency funding, and without monitoring of fund administration to prevent racial discrimination, Black- and minority-owned businesses are particularly vulnerable during a recession.

Because minority-owned small businesses often operate in communities that are especially negatively impacted by a recession, the financial institutions that serve these businesses are vulnerable too. ShoreBank, a well-known community bank that aimed to invest in inner-city Chicago, was unable to survive the 2008 financial crisis.⁵³ ShoreBank processed smaller average transactions than other banks, making them less profitable.⁵⁴ Inner-city Chicago was hit particularly hard by the 2008 financial crisis and had high unemployment.⁵⁵ As a result, ShoreBank eventually ran out of capital and declared insolvency.⁵⁶ Financial institutions that aim to serve low-income or minority communities face similar problems to ShoreBank—they are often less profitable⁵⁷ and more exposed to risk.

3. Reform Efforts Have Had Limited Effects on Addressing the Gap in Access to Credit for Low-Income Minority Borrowers

To promote community development in low-income areas, Congress passed the Riegle Community Development and

⁵¹ *Id.*

⁵² *Id.*

⁵³ BARADARAN, *supra* note 2, at 162, 165.

⁵⁴ *Id.* at 164.

⁵⁵ *Id.* at 165.

⁵⁶ *Id.* at 164.

⁵⁷ *See infra* Section II.B.iii.

Regulatory Improvement Act in 1994.⁵⁸ The Act created the CDFI Fund, which provides financial and technical assistance⁵⁹ to CDFIs.⁶⁰ The legislation defines a CDFI as an institution that “(i) has a primary mission of promoting community development; (ii) serves an investment area or targeted population; (iii) provides development services . . . ; [and] (iv) maintains, through representation on its governing board or otherwise, accountability to residents of its investment area or targeted population”⁶¹

CDFIs may receive financial assistance in the form of equity investments, deposits, credit union shares, loans, or grants.⁶² Institutions receiving financial assistance from the CDFI Fund must match the funds dollar-for-dollar with funding from external sources.⁶³ To receive funding, institutions must sign an assistance agreement with the CDFI Fund to meet agreed-upon performance goals.⁶⁴ Failure to meet those performance goals may result in the reduction or termination of financial assistance, or other sanctions.⁶⁵

⁵⁸ Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (1994).

⁵⁹ 12 U.S.C. § 4704(a) (2018) (identifying the types of assistance offered by the CDFI Fund).

⁶⁰ *Id.* § 4703(a) (establishing the CDFI Fund).

⁶¹ *Id.* § 4702(5)(A). “Development services” are defined as “activities that promote community development” such as business planning, financial and credit counselling, and marketing and management assistance. *Id.* § 4702(9). “Investment areas” include areas that meet “objective criteria of economic distress” and have “significant unmet needs for loans or equity investments.” *Id.* § 4702(16). “Low-income” as defined in the Act means an income of eighty percent or less of the area median income, or, for nonmetropolitan areas, eighty percent of the greater of the area median income and the statewide nonmetropolitan area median income. *Id.* § 4702(17). “Targeted population” is defined as individuals who are low-income or “otherwise lack adequate access to loans or equity investments.” *Id.* § 4702(20).

⁶² *Id.* § 4707(a)(1)(A).

⁶³ *Id.* § 4707(c)(1).

⁶⁴ *Id.* § 4707(f)(2)(A).

⁶⁵ *Id.* § 4707(f)(2)(C).

Today, there are over 1,000 CDFIs.⁶⁶ But these institutions play a limited role in funding small businesses.⁶⁷ CDFIs evaluate factors beyond quantitative criteria,⁶⁸ offering loans to those whose applications do not have the credit data required to obtain a loan from a large bank.⁶⁹ However, CDFIs have weaker financial performance compared to traditional peers⁷⁰ and often charge higher interest rates than commercial banks.⁷¹ Ultimately, though CDFIs have

⁶⁶ See *CDFI Certification*, CDFI FUND, <https://www.cdfifund.gov/programs-training/certification/cdfi/Pages/default.aspx> (on file with the Columbia Business Law Review) (click on the link that says “view the list of certified CDFIs” to download a spreadsheet of certified CDFIs) (showing there were 1,395 certified CDFIs as of March 14, 2022).

⁶⁷ Only one percent of small businesses used CDFIs for funding in the last five years. FED. RSRV. BANKS, *supra* note 6, at 8.

⁶⁸ *The Community Reinvestment Act: Assessing the Law’s Impact on Discrimination and Redlining: Hearing Before the H. Subcomm. On Consumer Prot. and Fin. Insts. of the H. Comm. on Fin. Serv.*, 116th Cong. 34 (2019) (statement of Benson Doyle Mitchell, Jr., President and CEO, Indust. Bank) (stating that, given a hypothetical where two borrowers in a low- or moderate-income neighborhood approach a CDFI, where one borrower makes 125% of the national median income and the other makes 75% of the national median income, the CDFI will “look[] at the story,” do their own research, and could lend to either borrower).

⁶⁹ Noelle St. Clair, *Capital for Communities: CDFIs Innovate on Small Consumer Loans*, FED. RSRV. BANK OF PHILA., <https://www.philadelphiafed.org/community-development/credit-and-capital/capital-for-communities-cdfis-innovate-on-small-consumer-loans> [<https://perma.cc/AH8X-43ZH>] (“Unlike traditional financial institutions, which deem individuals with limited credit history as “unscorable,” Oportun uses a proprietary system that leverages advanced data analytics...to determine a loan applicant’s ability to repay[.]”); Miriam Cross, *Fintech, CDFI Offer Small-Dollar Loan with New Twist*, AM. BANKER (Dec. 15, 2021, 5:04 PM), <https://www.americanbanker.com/news/fintech-cdfi-offer-small-dollar-loan-with-new-twist> [<https://perma.cc/5F7W-D6JX>] (describing a partnership between a CDFI and a fintech company that offers loans to borrowers with limited credit histories).

⁷⁰ BARADARAN, *supra* note 26, at 231.

⁷¹ Chris Motola, *What Is a Community Development Financial Institution (CDFI) & Is a CDFI Loan Right for My Small Business?*, MERCHANT MAVERICK (Nov. 18, 2019),

channeled investment into low-income communities,⁷² their effect in addressing widespread lack of access to low-cost credit has been extremely limited.

In 1977, Congress passed the Community Reinvestment Act (CRA) to encourage financial institutions “to help meet the credit needs of the local communities in which they are chartered.”⁷³ The CRA requires banks to prepare annual reports describing how they were meeting the credit needs of low- to moderate-income residents.⁷⁴ A negative CRA rating could be grounds for denying a merger or other change that requires regulatory approval.⁷⁵ Banks rarely receive a negative CRA rating, however.⁷⁶ The CRA has been criticized for being process-oriented rather than outcome-oriented,⁷⁷ suggesting their impact on narrowing racial wealth disparities has been limited. Banks can satisfy their CRA requirements with activities that do not necessarily help minorities or low-income communities.⁷⁸

<https://www.merchantmaverick.com/take-business-loan-cdfi>
[<https://perma.cc/RB25-KKNH>].

⁷² See Ofer Eldar, *Designing Business Forms To Pursue Social Goals*, 106 VA. L. REV. 937, 978 (2020) (arguing that the CDFI works well as a legal form for a corporate subsidy program).

⁷³ Community Reinvestment Act of 1977, 12 U.S.C. § 2901 (2018).

⁷⁴ BARADARAN, *supra* note 26, at 233.

⁷⁵ *Id.*

⁷⁶ Ninety-eight percent of banks receive a CRA passing grade. *The Community Reinvestment Act: Assessing the Law’s Impact on Discrimination and Redlining: Hearing Before the H. Subcomm. On Consumer Prot. and Fin. Insts. of the H. Comm. on Fin. Serv.*, 116th Cong. 8 (2019) [hereinafter *Hearings*] (statement of Jesse Van Tol, Chief Exec. Officer, Nat’l Cmty. Reinvestment Coalition).

⁷⁷ *Id.* at 27 (statement of Mehrsa Baradaran, Professor of L., Univ. of Ga. Sch. Of L.) (“[O]ne of the things that happened before the crisis is we had a bunch of regulatory box-checking for safety and soundness. . . . [and] if we are looking for the CRA to fix the racial wealth gap . . . then we should look at outcomes: Are you infusing capital and wealth into these communities, or are you not?”).

⁷⁸ *Id.* at 15 (2019) (statement of Aaron Glantz, Senior Rep., Reveal from the Ctr. for Investigative Reporting) (explaining how banks can comply with the CRA by making loans to white newcomers in rapidly gentrifying

Finally, credit reforms such as the Fair Credit Reporting Act⁷⁹ and the Equal Credit Opportunity Act⁸⁰ aimed to redress predatory lending practices have had a limited effect on increasing access to credit because these reforms did not address the underlying wealth disparity between Black and white households.⁸¹ Though these reforms sought to eliminate discrimination in credit applications, lenders continued to deny credit to Black applicants by using zip codes as a proxy for race.⁸² Furthermore, studies have shown that people who agree to high interest rates know they are overpaying for credit, but they choose to do so anyway because they have no better alternatives.⁸³ Reforms that aim to educate borrowers on the risks of predatory lending do help people who already understand those risks.

The lack of access to affordable credit keeps lower-income individuals, many of whom are minorities, on the fringes of the credit market. Furthermore, borrowers who use alternative lenders are sometimes not given the ability to build a credit history that would qualify them for bank loans, thus perpetuating their reliance on alternative lenders.⁸⁴ Additionally, small business borrowers who use alternative

neighborhoods or open physical locations that are not deposit-taking bank branches to avoid being subject to CRA requirements in those markets).

⁷⁹ Pub. L. 91-508, 84 Stat. 1227 (1970) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

⁸⁰ Pub. L. 93-380, 88 Stat. 516 (1974) (codified at 20 U.S.C. §§ 1701–1758).

⁸¹ BARADARAN, *supra* note 26, at 150.

⁸² *Id.*

⁸³ See Nakita Q. Cuttino, *The Rise of “FringeTech”: Regulatory Risks in Early Wage Access*, 115 NW. L. REV. 1505, 1549–50 (2021) (explaining that payday lenders are often the best and only option for individuals with poor or limited credit histories who require immediate liquidity); see also BARADARAN, *supra* note 2, at 129 (“Fringe loans, like payday and title loans, exist because a large portion of the population needs them.”).

⁸⁴ Cuttino, *supra* note 83, at 1553 (“Moreover, by not reporting positive repayment history to credit bureaus, payday lenders keep payday borrowers on the lowest rungs of the lending ladder.”).

lenders may face difficulties in accessing federal government funding programs during a recession.⁸⁵

Online lenders have emerged to fill the gap in access to credit for small businesses.⁸⁶ However, like payday lenders and other fringe lenders, they often charge high interest rates,⁸⁷ and because they are not subject to banking regulation, they are also not subject to liquidity requirements.⁸⁸ As a result, borrowers who rely on these lenders may encounter issues accessing funds in times of economic crisis.⁸⁹ Part III examines the business model of online lenders and explores how these lenders may expose borrowers to risk.

III. ONLINE LENDERS FILL A GAP IN THE CREDIT MARKET FOR SMALL BUSINESS LOANS

Borrowers of online lenders are often creditworthy individuals or business owners who have limited formal credit data.⁹⁰ Minority business owners often fall into this category, either because they have limited credit history and data, or because they have limited wealth and assets they can supply as collateral.⁹¹ As large banks have shifted away from providing small-dollar loans,⁹² online lenders have emerged to fill this gap in access to credit for small business borrowers.⁹³

There are many different types of online lenders, ranging from fintech marketplaces and peer-to-peer (“P2P”) lending platforms to ecommerce platforms, such as Square and PayPal, that offer lending services.⁹⁴ As these lenders all use fintech, the terms “online lenders” and “fintech companies”

⁸⁵ See *supra* Section II.B.ii.

⁸⁶ See *infra* Part III.

⁸⁷ See *infra* Section III.A.ii.

⁸⁸ See *infra* Section III.B.ii.

⁸⁹ For a discussion of online lenders facing liquidity problems during the COVID-19 pandemic, see *supra* Section III.B.ii.

⁹⁰ See FINREG LAB, *supra* note 4, at 9.

⁹¹ See *id.*

⁹² Mills & McCarthy, *supra* note 6, at 42 fig.25.

⁹³ *Id.* at 3.

⁹⁴ *Id.* at 53–54.

will be used interchangeably. Online lenders to small businesses tend to fall within two categories: (1) marketplace lenders that match borrowers with lenders, such as Lending Club, Prosper, and Funding Circle, and (2) online balance sheet lenders that offer a variety of funding sources, such as Kabbage and OnDeck Capital.⁹⁵ Both marketplace lenders and online balance sheet lenders use their own risk assessment model to determine whether a potential borrower is creditworthy.⁹⁶

A. Business Models of Online Lenders

Marketplace lenders fund loans by matching borrowers with lenders.⁹⁷ Investors are given information about loans which they can fund. Investors either select which loans to fund, or the platform can automatically assign loans to them based on their preselected criteria.⁹⁸ Online balance sheet lenders, on the other hand, have a variety of funding sources. OnDeck Capital, which offers short-term loans and lines of credit, originates loans using funding from committed debt facilities and securitization facilities.⁹⁹ In contrast, Kabbage offers merchant cash advance loans, providing working capital to businesses in exchange for a percentage of the businesses' future receivables.¹⁰⁰

⁹⁵ *Id.* at 54–55.

⁹⁶ *Id.* at 71–72.

⁹⁷ Mills & McCarthy, *supra* note 6, at 54–55.

⁹⁸ See, e.g., LendingClub Corp., Registration Statement (Form S-3), 41, 49 (Aug. 9, 2019) (describing Lending Club's business model for its Standard Program Loans).

⁹⁹ On Deck Capital, Inc., Annual Report (Form 10-K) (Mar. 2, 2018).

¹⁰⁰ *KBRA Assigns Preliminary Ratings to Kabbage Asset Securitization LLC, Series 2019-1 Additional Notes*, BUS. WIRE (Nov. 12, 2019, 2:49 PM), <https://www.businesswire.com/news/home/20191112005999/en/KBRA-Assigns-Preliminary-Ratings-to-Kabbage-Asset-Securitization-LLC-Series-2019-1-Additional-Notes> [<https://perma.cc/X4Y6-8696>]; *Working Capital Loans*, KABBAGE, <https://www.kabbage.com/working-capital> (on file with the Columbia Business Law Review) (last visited Apr. 25, 2022).

Online lenders differ from banks in that they do not take deposits or originate loans themselves,¹⁰¹ exempting them from state-level licensing requirements for loan origination.¹⁰² Marketplace platforms generally issue a series of notes for a loan. A bank will originate and disburse that loan to the borrowers, then sell it to the marketplace platform in exchange for the principal amount received from the sale of the issued notes in connection to the disbursed loan.¹⁰³

Such companies can provide services beyond loans. Kabbage, for example, offers a payments service on its platform along with checking accounts and a dashboard where small businesses could monitor cash flow.¹⁰⁴ Many of these lenders have been acquired or halted their services as a result of the COVID-19 pandemic. LendingClub has announced it would discontinue its peer-to-peer lending business;¹⁰⁵ American Express has acquired Kabbage's technology and teams, which it plans to use to make loans to small

¹⁰¹ Moran Ofir & Ido Sadeh, *A Revolution in Progress: Regulating P2P Lending Platforms*, 16 N.Y.U. J.L. & BUS. 683, 695 (2020); see also LendingClub Corp., Registration Statement (Form S-3), 41, 56 (Aug. 9, 2019). LendingClub's small business loans are offered under its Custom Program Loans. *Id.* LendingClub does not issue notes for loans through the Custom Program; these are only available through private transactions with accredited investors. *Id.*

¹⁰² LendingClub Corp., Registration Statement (Form S-3), 61 (Aug. 9, 2019). Such platforms may require licenses to broker, acquire, service, and enforce loans, however. *Id.*

¹⁰³ Ofir & Sadeh, *supra* note 101, at 695. Platforms may seek to help lenders mitigate this risk by offering auto-investment tools that allow lenders to diversify their portfolios as well as contingency funds that cover losses if a borrower defaults. *See id.* at 698.

¹⁰⁴ Penny Crosman, *Why Amex Is Buying Kabbage*, AM. BANKER (Aug. 18, 2020, 3:35 PM), <https://www.americanbanker.com/news/why-amex-is-buying-kabbage> [<https://perma.cc/LHH6-GAFM>].

¹⁰⁵ Lending Club announced that retail investors will no longer be able to fund consumer loans on its platform. Kevin Wack, *End of an Era: Lending Club To Drop P2P Platform*, AM. BANKER (Oct. 8, 2020, 4:43 PM), <https://www.americanbanker.com/news/end-of-an-era-lendingclub-to-drop-p2p-platform> [<https://perma.cc/SZG2-VSPC>].

businesses;¹⁰⁶ and OnDeck Capital has been acquired by ENOVA, an international fintech company.¹⁰⁷

1. Online Lenders Use Their Own Proprietary System To Underwrite Loans

To underwrite loans for small businesses, online lending platforms often evaluate non-traditional sources of credit information, relying on data such as current bank account information, sales data from online marketplaces, shipping data, and cash flow analysis.¹⁰⁸ Kabbage, for example, does not require financial statements, lease agreements, or tax history,¹⁰⁹ but does require small businesses to grant the company access to at least one of their Amazon, eBay, Xero, and other e-commerce or accounting website accounts to assess creditworthiness.¹¹⁰ Platforms may also analyze social media data to project a business's profitability, for example, by looking at a store's rating on Yelp¹¹¹ or examining what customers say about the business on their social media pages.¹¹²

¹⁰⁶ Crosman, *supra* note 104.

¹⁰⁷ Kevin Wack, *Why OnDeck Is Being Sold on the Cheap*, AM. BANKER (July 29, 2020, 1:42 PM), <https://www.americanbanker.com/news/why-ondeck-capital-is-going-for-a-fire-sale-price> [<https://perma.cc/4BSJ-MJXT>].

¹⁰⁸ Mills & McCarthy, *supra* note 6, at 46; Julapa Jagtiani & Catherine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 30 (Fed. Rsrv. Bank of Phila., Working Paper No. 17-17, 2017), <https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-17th/papers/14-jagtiani.pdf> [<https://perma.cc/9NTK-H3JD>].

¹⁰⁹ Geri Stengel, *Kabbage: The Care and Feeding of a Fintech Unicorn*, FORBES (Oct. 30, 2019, 7:00 AM), <https://www.forbes.com/sites/geristengel/2019/10/30/kabbage-the-care-and-feeding-of-a-fintech-unicorn> [<https://perma.cc/R253-7MV2>].

¹¹⁰ Stephanie Armour, *Borrowers Hit Social-Media Hurdles; Regulators Have Concerns About Lenders' Use of Facebook, Other Sites*, WALL ST. J. (Jan. 8, 2014, 5:51 PM), <https://www.wsj.com/articles/borrowers-hit-socialmedia-hurdles-1389224469> (on file with the Columbia Business Law Review).

¹¹¹ Jagtiani, *supra* note 108, at 8.

¹¹² Armour, *supra* note 110.

The non-traditional credit data online lenders use plays an important role in assessing a prospective borrower's creditworthiness. Lending Club assigns borrowers a rating grade, which estimates the borrower's likelihood of default.¹¹³ To assign a rating grade, the lender considers "behavioral data, transactional data and employment information" in addition to a borrower's FICO score.¹¹⁴ The correlation between a borrower's FICO score and rating grade from Lending Club has steadily decreased over time from over eighty percent in 2007 to approximately thirty-five percent in 2016,¹¹⁵ suggesting that non-traditional credit data is playing a larger role in Lending Club's internal rating calculation. Indeed, over twenty-five percent of borrowers rated B, the second highest of Lending Club's seven rating grades, have FICO scores in the subprime range.¹¹⁶ Furthermore, the rate of default decreases as rating grades of loans are higher,¹¹⁷ suggesting that Lending Club's proprietary algorithm is effectively assessing a borrower's ability to repay. Though these results relate to consumer loans,¹¹⁸ they suggest that alternative data can accurately predict creditworthiness, which could then also be used for small business loans. In other words, there is potential for online platforms to use promising social media reviews and sales numbers as a basis for offering loans to businesses that have limited credit information and assets. Minority business owners, who often lack formal credit requirements, could benefit from these alternative underwriting criteria.

Underwriting with non-traditional criteria is not without its risks—platforms risk misinterpreting the data or

¹¹³ LendingClub Corp., Annual Report (Form 10-K) 9 (Feb. 19, 2020).

¹¹⁴ *Id.* In general, online lenders may consider factors such as "consumers' payment history (utility, phone, PayPal, Amazon), their medical and insurance claims, [and] their social network[.]" Jagtiani, *supra* note 108, at 24.

¹¹⁵ Jagtiani, *supra* note 108, at 25.

¹¹⁶ *Id.* at 26.

¹¹⁷ *Id.* at 30–31.

¹¹⁸ *Id.* at 12.

confusing correlation with causation,¹¹⁹ or making biased decisions by relying on soft information such as applicants' appearances.¹²⁰

2. Online Lenders Offer High Interest Rates To Mitigate Risk

Marketplace lending platforms continue to grow as investors, attracted by high returns, continue to fund loans on these platforms.¹²¹ Platforms, such as Lending Club, are not limited by usury laws where their issuing bank is in a state with no interest rate cap. For example, WebBank, the issuing bank of several online lenders, is chartered in Utah, where there is no statutory limit on interest rates on personal loans.¹²² For some time, there was uncertainty over whether a purchaser of a loan, in this case the online lender, could charge the same interest rate if that rate was higher than the usury cap in the state which the purchaser operated.¹²³ An Office of the Comptroller of the Currency (OCC) rule has since confirmed that online lenders can charge the higher interest

¹¹⁹ EDITH RAMIREZ ET AL., FED. TRADE COMM'N, *BIG DATA: A TOOL FOR INCLUSION OR EXCLUSION?* 29 (2016), <https://www.ftc.gov/system/files/documents/reports/big-data-tool-inclusion-or-exclusion-understanding-issues/160106big-data-rpt.pdf> [<https://perma.cc/D2GY-TW6D>]; Taylor Moore, *Peer-To-Peer (P2P) Lending*, TIME: NEXTADVISOR (Sept. 8, 2021), <https://time.com/nextadvisor/loans/personal-loans/peer-to-peer-lending/> [<https://perma.cc/4GK8-GP6P>].

¹²⁰ Previous studies have reported that an applicants' looks and relational network is related to the applicant's success in receiving funding or obtaining a better price for the funding. Jagtiani, *supra* note 108, at 8.

¹²¹ Mills & McCarthy, *supra* note 6, at 46.

¹²² LendingClub Corp., Registration Statement (Form S-3), 12 (Aug. 9, 2019). To maintain their offering of loans at interest rates of 6.46% to 28.80%, *id.* at 7, Lending Club relies on "(i) the application of federal law to enable an issuing bank that originates the loan to 'export' the interest rates of the jurisdiction where it is located[.]" *Id.* at 12.

¹²³ *See id.*

rate, clarifying that “a bank may transfer a loan without affecting the permissible interest term.”¹²⁴

On marketplace lenders’ platforms, loans with higher interest rates are more likely to be funded.¹²⁵ Online lending platforms make most of their revenue from loan origination fees, thus they have a strong incentive to originate loans with high interest rates. Because their revenue from servicing fees, paid upon loan reimbursement, is lower,¹²⁶ lenders tend to absorb the risk of a borrower defaulting more than the platform does.¹²⁷ In summary, the platform has a stronger financial incentive to originate loans than to ensure they are all repaid. However, the platform would likely suffer significant reputation costs if borrowers consistently default.

B. The Effects of Online Lending on Minority Business Borrowing

Through using alternative sources of data to assess creditworthiness, online lenders offer loans to customers who cannot otherwise borrow from a bank, allowing more people to participate in the credit ecosystem. This increased financial inclusion often comes at the cost of a higher interest rate, which can be especially risky for borrowers if they are not fully informed about loan terms beforehand. In addition, online lenders may undergo liquidity problems during an economic downturn, exposing borrowers to additional risk.

¹²⁴ Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 85 Fed. Reg. 33,530, 33,530 (Jun. 2, 2020) (to be codified at 12 C.F.R pts. 7, 160); see 12 C.F.R. §§ 7.4001, 160.110 (2021).

¹²⁵ Ofir & Sadeh, *supra* note 101, at 739.

¹²⁶ *Id.* at 738.

¹²⁷ Platform may still be incentivized to assess creditworthiness carefully, however, to maintain the reputation of their business in the long run. Kevin Davis & Jacob Murphy, *Peer-to-peer Lending: Structures, Risks and Regulation*, JASSA FINANCIAL J. APPLIED FIN., Oct. 31, 2016, at 39.

1. Online Lenders Offer More Opportunities for Small Business Owners To Obtain Loans and Access Government Programs

There is some data to suggest that online lenders are fulfilling demand for small business loans when banks leave markets.¹²⁸ If online lenders were to take on a larger role in the financial system, this could ultimately benefit minority-owned businesses, which often have weaker banking relationships than white-owned businesses.¹²⁹ In April 2020, through PPP, non-bank companies, including fintech companies, were authorized to distribute Small Business Administration (SBA) loans for the first time.¹³⁰ Because small businesses and minority-owned businesses are less likely to access credit from large banks, they often turn to fintech.¹³¹ Thus, by allowing online lenders to administer SBA loans, their customers gain access to government programs such as PPP.

2. The Business Models of Online Lenders Can Be Volatile, Providing Customers with Less Stability

Because online lenders generally use an issuing bank to originate loans, or otherwise fund them through debt or securitization,¹³² they are not subject to the capital and liquidity requirements imposed on banks. As a result, online

¹²⁸ A study from October 2014 to March 2015 shows that twenty-five percent of PayPal Working Capital loans went to the three percent of counties that lost ten or more banks since the financial crisis. Mills & McCarthy, *supra* note 6, at 47–48 (citing Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, INNOVATIONS: TECH. & GOVERNANCE, July 1, 2015).

¹²⁹ See Flitter, *supra* note 36.

¹³⁰ Olivia Rockeman, *Fintechs Poised To Lock in Sudden Success Courtesy of Crisis Era*, BLOOMBERG L. (May 4, 2020, 9:16 AM), <https://www.bloomberglaw.com/product/blaw/document/X1TO7DFC000000> [<https://perma.cc/3UVV-E37F>].

¹³¹ Mills & McCarthy, *supra* note 6, at 3.

¹³² For a discussion of the business models of online lenders, see *supra* Section III.A.

lenders can and do experience liquidity problems during economic recessions.

Banks are subject to the Bank Holding Company Act¹³³ and related regulations, including Regulation Q, which establishes minimum capital requirements¹³⁴ and overall capital adequacy standards.¹³⁵ These requirements are recommended by the Basel Committee on Banking Supervision to enhance the financial stability of banks around the world.¹³⁶ By following capital requirements, banks build up capital to use in times of financial stress, avoid taking on unnecessary risk, and are better equipped to handle economic downturns, providing customers and the public with greater stability.¹³⁷

Because online lenders are not subject to these requirements, their customers may face greater uncertainty over whether they can obtain loans during an economic downturn. The risk of illiquidity is especially great with online lenders that lend to small businesses. OnDeck, an online

¹³³ Pub. L. 84-511, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. § 1841–1849).

¹³⁴ 12 C.F.R. § 217.10(a)(1) (2021) (“A Board-regulated institution must maintain the following minimum capital ratios: (i) A common equity tier 1 capital ratio of 4.5 percent. (ii) A tier 1 capital ratio of 6 percent. (iii) A total capital ratio of 8 percent. (iv) A leverage ratio of 4 percent. (v) [requirements for certain specified institutions].”). Requirements (i) to (iii) compare the institution’s capital in the specified category to the institution’s standardized total risk-weighted assets. The leverage ratio is the institution’s tier 1 capital to the institution’s average total consolidated assets. *Id.* §217.10(b).

¹³⁵ *Id.* § 217.10(e)(1) (“Notwithstanding the minimum requirements in this part, a Board-regulated institution must maintain capital commensurate with the level and nature of all risks to which the Board-regulated institution is exposed.”).

¹³⁶ *Basel Committee Charter*, BIS (June 5, 2018), <https://www.bis.org/bcbs/charter.htm> [<https://perma.cc/M8UB-DU4M>]. The Basel Committee on Banking Supervision does not possess authority to mandate regulations. *Id.*

¹³⁷ See, e.g., JIHAD DAGHER ET AL., IMF STAFF DISCUSSION NOTE: BENEFITS AND COSTS OF BANK CAPITAL (2016), <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf> (on file with the Columbia Business Law Review).

lender which specialized in lending to small businesses, experienced a sharp decline in loans and finance receivables as the COVID-19 pandemic struck. At the end of June 2020, 39.5% of OnDeck's loans were at least 15 days past due, compared to 10.3% three months earlier.¹³⁸ OnDeck stopped originating loans in May 2020.¹³⁹ Many of Kabbage's borrowers went out of business during the COVID-19 pandemic.¹⁴⁰ Kabbage stopped originating loans and instead used their platform to administer PPP loans.¹⁴¹

3. Some Platforms May Impose Predatory Loan Terms

Interest rates on loans originated by online platforms can vary greatly.¹⁴² Furthermore, if loans must be paid back with a short period of time, the annual percentage rate (APR) can be astronomical. Of the borrowers that applied to the Opportunity Fund for refinancing, the average APR on their loan(s) was 94%, with the APR on one loan being as high as 358%.¹⁴³

From the perspective of a lender, higher interest rates may be warranted, given the risk of the investment. Loans originated on online lending platforms are generally unsecured, with lenders only receiving payment to the extent

¹³⁸ See On Deck Capital, Inc., Quarterly Report (Form 10-Q), 27 (Aug. 7, 2020).

¹³⁹ Wack, *supra* note 107.

¹⁴⁰ Derek Willis & Lydia DePillis, *Hundreds of PPP loans Went to Fake Farms in Absurd Places*, COUNTER (May 19, 2021, 1:14 PM), <https://thecounter.org/hundreds-ppp-loans-fake-farms-kabbage-sba/> [<https://perma.cc/F9MJ-HGNJ>].

¹⁴¹ Crosman, *supra* note 104.

¹⁴² See Mae Anderson, *Small Businesses in Need of a Loan Find Banks Are Stingy*, ABC N. (Apr. 4, 2022, 11:04 AM), <https://abcnews.go.com/Business/wireStory/small-businesses-loan-find-banks-stingy-83863360> [<https://perma.cc/Q23T-8HVB>].

¹⁴³ ERIC WEAVER, GWENDY DONAKER BROWN & CAITLIN MCSHANE, UNAFFORDABLE AND UNSUSTAINABLE: THE NEW BUSINESS LENDING ON MAIN STREET 3 (2016), https://aofund.org/app/uploads/2021/03/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf [<https://perma.cc/6CD4-LXAP>].

that the borrower has made payments on the loan.¹⁴⁴ Moreover, allowing higher interest rates may be necessary to ensure access to credit for higher-risk borrowers: An empirical study showed that *Madden v. Midland Funding, LLC*,¹⁴⁵ which caused uncertainty over whether interest rates exceeding the usury cap would be enforced, resulted in a decline in marketplace lending to higher-risk borrowers in Connecticut and New York.¹⁴⁶ Specifically, there was a decline in new loans above the state usury rates in Connecticut and New York, while new loans under the usury rate continued to grow on pace with other states.¹⁴⁷ Furthermore, the decline was attributable to high-risk borrowers receiving fewer loans, not high-risk borrowers being charged lower interest rates—borrowers with lower FICO scores, especially those with scores below 625, sharply declined.¹⁴⁸ Because loans with higher interest rates are harder to repay, Lending Club borrowers who had a higher interest rate have higher probabilities of default.¹⁴⁹

In summary, online lenders provide loans to those with limited credit data but fail to serve as a *consistent* source of access to credit, particularly for small business borrowers. Furthermore, though higher interest rates may be warranted by the additional risk online lenders are taking on, some

¹⁴⁴ See LendingClub Corp., Registration Statement (Form S-3), 17 (Aug. 9, 2019).

¹⁴⁵ 786 F.3d 246 (2d Cir. 2015). *Madden* has since been overruled by the OCC rule. See *supra* note 124 and accompanying text.

¹⁴⁶ Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, 60 J.L. & ECON. 673, 675 (2017). One study found that lenders stopped lending to borrowers who were likeliest to borrow above usury rates after the *Madden* decision. *Id.* While there were hundreds of loans issued to borrowers in Connecticut and New York with FICO scores below 640 in the first half of 2015, there were none after July 2015. *Id.* At the same time, loans to highest-risk borrowers were still being made in other states. *Id.* at 676.

¹⁴⁷ *Id.* at 694.

¹⁴⁸ *Id.* at 697.

¹⁴⁹ Jagtiani, *supra* note 108, at 27.

platforms charge astronomical interest rates that are hard to repay.

IV. ONLINE LENDERS COULD PROVIDE MORE CONSISTENT ACCESS TO CREDIT IF THEY ARE SUBJECTED TO CAPITAL AND LIQUIDITY REQUIREMENTS

This Part outlines potential strategies to regulate online lending to ensure minority business owners have consistent access to credit. This Part proposes that the government impose capital and liquidity requirements on online lenders to ensure that they can continue serving borrowers during an economic downturn.¹⁵⁰

Section A argues that a program to increase online lending to minority business owners should incentivize lenders to invest in low-income and minority communities rather than impose a mandatory requirement. For online lenders that seek to offer services similar to those of banks, the OCC's proposal, discussed in Section B, would grant such companies a special purpose bank charter. The charter balances the imposition of regulatory requirements, including capital and liquidity requirements, with the goal of allowing fintech companies to maintain their innovative business models. Section C proposes a program that would incentivize online lenders to invest in low-income communities through a subsidy program similar to the CDFI program, which certifies certain online lenders for providing a substantial amount of loans in low-income communities. Certification makes these lenders eligible for government grants, conditioned upon the funding being used to maintain capital reserves.

A. An Incentive-Based System Allows Online Lenders To Preserve Their Innovation-Based Business Model

Online lenders emerged to fill a gap in the credit market, differentiating them from banks. Banks have traditionally

¹⁵⁰ A discussion of solutions to predatory pricing is beyond the scope of this Note.

been viewed as institutions serving the public: Professor Baradaran posits that banking reforms from The New Deal and the civil rights eras created a “social contract” between banks and the public.¹⁵¹ Under this view of banks as public-serving institutions, it makes sense to subject banks to mandatory financial requirements such as the CRA.¹⁵² Online lenders do not have that same history of serving the public, thus there is less of a compelling argument for subjecting them to mandatory financial inclusion requirements. Similarly, because comprehensive regulation of banks is partly due to their importance in the economy,¹⁵³ there is less of a compelling argument for subjecting online lenders to mandatory capital and liquidity requirements.

Online lenders emerged as a solution to fulfill a consumer need. As banks made less small-dollar loans, online lenders stepped in to fill that need using predictive technology to offer loans to those with limited credit data. Increased regulation may impose costs on online lenders that ultimately hinder their ability to innovate. Consequently, a proposal to enhance the financial inclusion capabilities of fintech should *incentivize* lenders to invest in minority-owned businesses rather than requiring them to.

¹⁵¹ BARADARAN, *supra* note 2, at 44–51 (describing how The New Deal reforms to limit banks’ power and increase access to consumer credit created a “social contract” between banks and the public; and civil rights era laws prohibiting discrimination in banking amended the social contract to include racial minorities); *see also Hearings*, at 9 (statement of Mehrsa Baradaran, Professor of L., Univ. of Ga. Sch. Of L.) (“The underlying theory of the CRA is that banks have duties to the public because they benefit from significant government subsidies.”).

¹⁵² 12 U.S.C. § 2903(a)–(b) (2018).

¹⁵³ The Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Pub. L. 111-203, 124 Stat. 1376 (2010), which imposed substantial financial regulation reforms, was aimed at the largest banks and in fact exempted smaller banks from many of the rules in the Act. Kress & Turk, *supra* note 3, at 669. Furthermore, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), Pub. L. 115-174, 132 Stat. 1296 (2018) exempts community banks from risk-based capital requirements and the Volcker Rule. *Id.* at 685, 690, 692.

B. The OCC's Special Purpose National Bank Charter Could Bring Online Lenders Under Federal Banking Supervision but Does Not Adequately Address Investment in Minority Communities

In 2016, OCC published a plan to grant special purpose national bank charters to fintech companies in an effort to bring fintech companies under federal banking supervision.¹⁵⁴ The special purpose national bank charter framework imposes capital and liquidity requirements on fintech companies while allowing such companies to maintain their business model.¹⁵⁵

Under the OCC's proposal, an entity must meet capital adequacy standards and minimum liquidity requirements to be granted a special purpose national bank charter.¹⁵⁶ With respect to capital adequacy, the OCC proposal requires that entities make a detailed business plan that outlines how they plan to maintain adequate capital to support their risk profile.¹⁵⁷ Though there is no formula determining what amount of capital is adequate, the OCC would consider the risks and complexities of the business and its products.¹⁵⁸ The OCC would also look to other elements, such as the entity's governance and operations, credit risks, and market risks.¹⁵⁹ Entities whose business activities may be off-balance sheet, such as certain fintech lenders, would be subject to the OCC's minimum regulatory capital requirements.¹⁶⁰ Where the minimum capital levels do not adequately reflect risks, the entity may have to propose a minimum level of capital.¹⁶¹ In

¹⁵⁴ OFF. OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES (2016), <https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-special-purpose-nat-bank-charters-fintech.pdf> [https://perma.cc/23YJ-RHA3].

¹⁵⁵ *Id.* at 2.

¹⁵⁶ *Id.* at 8.

¹⁵⁷ *Id.* at 9.

¹⁵⁸ *Id.* at 9–10.

¹⁵⁹ *Id.* at 9–10.

¹⁶⁰ *Id.* at 10.

¹⁶¹ *Id.*

addition, the OCC would require entities to maintain minimum levels of liquidity proportionate to the risk of their proposed activities, to ensure the business is able to meet unexpected cash flow and collateral needs.¹⁶² In particular, the OCC would look at the proposed bank's access to funds and its cost of funding.¹⁶³

Fintech companies have been reluctant to pursue a national charter.¹⁶⁴ In November 2020, Figure Technologies was the first company to apply for one.¹⁶⁵ However, even as fintech lenders are reluctant to apply for a national charter, they are seeking to perform more bank-like activities. After announcing that it would stop peer-to-peer lending, Lending Club stated it “plans to offer a full suite of products as a bank.”¹⁶⁶ It is possible that the special purpose national charter will grow in popularity as online lenders increasingly seek to expand their product offerings, as a national charter would allow online lenders to operate nationwide under a uniform set of standards.¹⁶⁷

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ Lalita Clozel, *'Fintech Charter' Has No Early Takers as Lawsuit Looms*, WALL ST. J. (Sept. 12, 2018, 11:00 AM), <https://www.wsj.com/articles/fintech-charter-has-no-early-takers-as-lawsuit-looms-1536764426> (on file with the Columbia Business Law Review). *But see Oportun Applies for National Bank Charter with the Office of the Comptroller of the Currency (OCC)*, OPORTUN (Nov. 23, 2020), <https://oportun.com/about/press/oportun-applies-for-national-bank-charter-with-the-occ/> [<https://perma.cc/QNY9-LPCH>]. The proposed Oportun Bank would provide traditional depository services to its consumers and seek deposits from socially conscious investors. Raul Vasquez, *Advancing Economic Equity Through Financial Inclusion*, OPORTUN, <https://oportun.com/about/press/advancing-economic-equity-through-financial-inclusion/> [<https://perma.cc/NEZ3-ZH4C>] (last visited Apr. 25, 2022).

¹⁶⁵ Kevin Wack, *A Fintech's Novel Bank Charter Application Draws Industry's Ire*, AM. BANKER (Dec. 2, 2020, 9:00 PM), <https://www.americanbanker.com/news/a-fintechs-novel-bank-charter-application-draws-industrys-ire> [<https://perma.cc/66S8-CFST>].

¹⁶⁶ LendingClub Corp., Current Report (Form 8-K) (Oct. 7, 2020).

¹⁶⁷ *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 154, at 4.

Notably, even if an entity were to gain a special purpose national bank charter, it would not be subject to the Community Reinvestment Act if it is not an insured depository institution.¹⁶⁸ Instead, the OCC would encourage such an entity “to provide fair access to financial services by helping to meet the credit needs of its entire community” and to explain its commitment to financial inclusion in its business plan.¹⁶⁹ Thus, even if large numbers of fintech companies began applying for the special purpose national charter, the lenders would not be required to invest in low-income or minority communities. Though the charter would bring online lenders under financial banking supervision, it does not go as far as the CRA in requiring such lenders to further financial inclusion.¹⁷⁰

Overall, the charter provides a framework for imposing capital and liquidity requirements on fintech companies while preserving their dynamic business model. However, the future of the charter is in question: The Conference of State Bank Supervisors (CSBS) challenged Figure Technologies’ application for a national bank charter, arguing that the charter preempts state authority to regulate non-banks.¹⁷¹ The CSBS later withdrew its lawsuit after Figure Technologies amended its charter application to offer FDIC-insured deposit accounts.¹⁷² It is uncertain whether the CSBS will challenge future charter applications by fintech

¹⁶⁸ *Id.* at 12 (citing Community Reinvestment Act, 12 U.S.C. 2902 (2015)). The Community Reinvestment Act defines “regulated financial institution” as an “insured depository institution.” 12 U.S.C. 2902 (2018).

¹⁶⁹ *Id.* (internal quotation marks omitted) (quoting 12 C.F.R. § 5.20(f)(1)(ii), (iv) (2021)).

¹⁷⁰ 12 U.S.C. § 2903(c)(1).

¹⁷¹ Lydia Beyoud, *States Sue To Block ‘First Fintech Charter’ Bank Application (1)*, BLOOMBERG L. (Dec. 22, 2020, 6:58 PM), <https://news.bloomberglaw.com/banking-law/states-sue-to-block-first-fintech-charter-bank-application> [<https://perma.cc/TGV4-F3TA>].

¹⁷² Scott A. Coleman, *CSBS Withdraws Lawsuit Seeking To Block OCC Approval of Figure Technologies Charter Application*, BALLARD SPAHR LLP (Jan. 19, 2022), <https://www.consumerfinancemonitor.com/2022/01/19/csbs-withdraws-lawsuit-seeking-to-block-occ-approval-of-figure-technologies-charter-application/> [<https://perma.cc/UM6M-FTY2>].

companies that do not intend to offer FDIC-insured deposit accounts.¹⁷³ Even if the charter were to remain a viable option for online lenders, this Note argues that additional solutions are needed to encourage lending in minority and low-income communities.

C. A CDFI-Like System for Incentivizing Online Lenders To Lend to Minority Business Owners

CDFIs play a crucial role in providing funding to minority businesses.¹⁷⁴ They act as a bridge between those outside the traditional credit market and the mainstream credit system.¹⁷⁵ To this end, the federal government has involved CDFIs in the effort to provide funding to small businesses during the COVID-19 pandemic.¹⁷⁶ In the round of funding that opened in January 2021, the federal government prioritized PPP funding to Black- and minority-owned small businesses by opening applications to community lenders before opening them to larger banks.¹⁷⁷

¹⁷³ Scott A. Coleman, *OCC Approves National Bank Charter Applications of Fintech Company*, BALLARD SPAHR LLP (Jan. 24, 2022), <https://www.consumerfinancemonitor.com/2022/01/24/occ-approves-national-bank-charter-applications-of-fintech-company/> [https://perma.cc/XQC9-9TPA].

¹⁷⁴ See, e.g., Mels G. de Zeeuw & Victor E. da Motta, *Minority-Owned Enterprises and Access to Capital from Community Development Financial Institutions*, CMTY. DEV. INNOVATION REV., Winter 2020–2021, at 5, 5.

¹⁷⁵ CMTY. DEV. FIN. INST. FUND, HOW DO THE CDFI FUND'S PROGRAMS WORK?, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi_infogrphic_v03aaf.pdf [https://perma.cc/GUC7-P8DV].

¹⁷⁶ Press Release, United States Treasury Dep't, *U.S. Treasury Awards \$1.25 Billion to Support Economic Relief in Communities Affected by COVID-19* (June 15, 2021), <https://home.treasury.gov/news/press-releases/jy0228> [https://perma.cc/2ETZ-W8HA].

¹⁷⁷ Stacy Cowley, *Small-Business Loan Program Will Restart Monday, but Not for All*, N.Y. TIMES (Jan. 8, 2021), <https://www.nytimes.com/2021/01/08/business/smallbusiness/ppp-loans-restart.html> [https://perma.cc/C4KP-2P4U]. Community lenders include CDFIs, Minority Depository Institutions, and Certified Development Companies, and make up approximately ten percent of the over 5,000 lenders involved in the PPP program. *Id.*

Fintech companies can become CDFIs. In 2019, Fig Loans became the first fintech company to receive a CDFI certification.¹⁷⁸ Combining the goals of online lending and community investment, Fig Loans began offering affordable loans to working class people in Texas, using predictive analytics for underwriting.¹⁷⁹ Fig Loans helps consumers repay their loans and establish credit by setting a maximum APR of 190%, extending loan repayment due dates without assessing fees, and reporting to credit agencies.¹⁸⁰ Fig Loans only offers loans in amounts of \$300 to \$750.¹⁸¹ Similarly, Oportun is a CDFI that uses its own credit scoring system to underwrite loans.¹⁸² Oportun offers loans between \$300 and \$10,000, caps APRs no higher than 35.99% and reports loan repayment to credit bureaus.¹⁸³ Oportun (then known as Progreso Financiero) was founded with the goal of providing loans to unbanked and underbanked Hispanic consumers in Texas and California but has since expanded to more states.¹⁸⁴

Fintech CDFIs use predictive analytics to offer affordable loans to those in low-income communities. To the extent that CDFIs are involved in federal government programs such as PPP, their status as CDFIs allows their borrowers access to

¹⁷⁸ *Fig Loans Becomes First FinTech To Receive CDFI and B Corp Certifications*, FIG LOANS (May 7, 2019, 11:00 AM), https://www.figloans.com/press/cdfi_houston [https://perma.cc/358Y-BK5K].

¹⁷⁹ *Id.*

¹⁸⁰ Eliza Platts-Mills & Justin Chung, *Challenging Payday Lenders by Opening up the Market for Small-Dollar Loans*, 33 BYU J. PUB. L. 101, 134–135 (2019).

¹⁸¹ *Philosophy: Financial Tools That Meet Immediate Needs and Build Future Wellbeing*, FIG LOANS, <https://www.figloans.com/about/responsible-lending-model> [https://perma.cc/A4FT-CZ6Z] (last visited Apr. 5, 2022).

¹⁸² Platts-Mills & Chung, *supra* note 180, at 138.

¹⁸³ *Affordable Personal Loans*, OPORTUN, <https://oportun.com/personal-loans/> [https://perma.cc/C49Y-L5Y4].

¹⁸⁴ Platts-Mills & Chung *supra* note 180. Oportun's customers earn \$46,000 per year on average. *Oportun Applies for National Bank Charter with the Office of the Comptroller of the Currency (OCC)*, OPORTUN (Nov. 23, 2020), <https://oportun.com/about/press/oportun-applies-for-national-bank-charter-with-the-occ/> [https://perma.cc/QNY9-LPCH].

funding during an economic downturn. Furthermore, these fintech companies are eligible for government loans and grants from the CDFI Program.¹⁸⁵ However, to receive these benefits, lenders must receive CDFI certification, which necessitates that they have a primary goal of promoting community development. Few fintech lenders are founded with such a primary goal.¹⁸⁶

The next Sections outline a proposal for a CDFI-like program that incentivizes fintech companies to invest in low-income or minority communities. In exchange for meeting a minimum level of investment, these lenders receive a certification, which can be called a “Community Investment Certification.” The certification will allow such lenders to apply for federal grants and attract investment from socially conscious investors. However, to maintain certification and to comply with conditions with receiving federal grants, the online lenders must maintain enough capital reserves to ensure they can continue to serve small businesses and other borrowers in the community they serve during an economic downturn. This CDFI-like program could be run by the CDFI Fund or another oversight body.

¹⁸⁵ 12 C.F.R. § 1805.201(b)(1) (2021). In determining whether a CDFI has a primary goal of promoting community development, the CDFI Fund considers whether the CDFI’s activities are intentionally “directed toward improving the social and/or economic conditions of underserved people . . . and/or residents of economically distressed communities.” *Id.*

¹⁸⁶ Indeed, many of the fintech companies that aim to serve disadvantaged communities are B Corps. For example, Fig Loans, a fintech CDFI, and CNote, an impact investing platform, are both B Corps. *Fig Loans Becomes First FinTech To Receive CDFI and B Corp Certifications*, BUS. WIRE (May 7, 2019, 11:05 AM), <https://www.businesswire.com/news/home/20190507005763/en/Fig-Loans-Becomes-First-FinTech-to-receive-CDFI-and-B-Corp-Certifications> [https://perma.cc/D529-BL9E]; *CNote Is Now a Certified B Corp*, CNOTE (Feb. 13, 2019), <https://www.mycnote.com/blog/cnote-is-now-a-certified-b-corp/> [https://perma.cc/Z9MJ-P6M5].

1. The Effectiveness of CDFIs in Increasing Access to Credit Can Be Attributed to the Certification Process and Subsidy Lock Mechanism

Professor Ofer Eldar has discussed the success of CDFIs as a corporate subsidy program that increases access to capital for low-income communities, specifically highlighting two features: the certification process and the subsidy lock.¹⁸⁷ The certification process ensures that financial institutions with CDFI certification transact with low-income communities and direct their activities towards serving those communities¹⁸⁸ and certification signals the social purpose of the organization to socially conscious investors.¹⁸⁹ The subsidy lock ensures that CDFIs use government awards for eligible activities only. To receive an award, CDFIs must enter an “assistance agreement” with the CDFI Fund and are subject to continued monitoring.¹⁹⁰

These two elements of the CDFI program, certification and the subsidy lock, provide the basis for a proposed CDFI-like system that will be outlined in the next two Sections.

2. A Modified CDFI Certification Process That Targets Low-Income Communities and Certain Small Businesses

Requirements for CDFI certification are strict. Particularly challenging to online lenders are the requirements that an institution must have “a primary mission of promoting community development,” serve a targeted community, provide technical assistance, and be held accountable to the communities they serve.¹⁹¹ These requirements ensure that CDFIs are effective tools for community empowerment. Most fintech lenders, with a few

¹⁸⁷ Ofer Eldar, *supra* note 54, at 980–81.

¹⁸⁸ *Id.* at 980.

¹⁸⁹ *Id.* at 984–85.

¹⁹⁰ *Id.* at 981.

¹⁹¹ 12 C.F.R. § 1805.201 (2021).

exceptions,¹⁹² were not founded with the primary goal of promoting community development.

Nevertheless, by using predictive analytics to underwrite loans, online lenders have the potential to greatly increase access to credit, especially for minority business owners who have limited credit data. With a CDFI-like certification program, the oversight body can recognize online lenders who lend substantially to those in populations targeted by CDFIs, by giving such lenders a “Community Investment Certification.”

A “Community Investment Certification” will require online lenders to serve a substantial part of a targeted community. Under the CDFI program, to receive CDFI certification an entity must serve either an “Investment Area,” typically an area in economic distress with a significant unmet need for loans¹⁹³ or a “Targeted Population” of those who are low-income.¹⁹⁴ Under this proposed program, online lenders can achieve “Community Investment Certification” by establishing a presence in a CDFI “Investment Area” and providing a substantial number of loans to meaningfully address the unmet need for loans. Certification can require that a certain percentage of those loans go to individuals below a certain income level, or that certain types of small businesses are served.

For instance, sole proprietors, who often provide important services to the community, may experience unique difficulties obtaining loans during economic downturns. Unprofitable sole proprietors were initially ineligible for PPP funding, leaving many “barbers, stylists, drivers . . . really small mom-and-pop businesses” outside the reach of PPP.¹⁹⁵ Furthermore, some

¹⁹² See *supra* Section IV.C.

¹⁹³ 12 C.F.R. § 1805.201. Unemployment rate, percentage of the population living in poverty, and median family income can be used to assess economic distress. *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ Stacy Cowley, ‘It Was a Joke’: Some Small Businesses Got \$1 Relief Loans, N.Y. TIMES (Mar. 9, 2021), <https://www.nytimes.com/2021/01/11/business/small-businesses-ppp-covid.html> [<https://perma.cc/Q65R-KKX2>].

sole proprietors that were eligible for funding received very little, which made the loans unprofitable for lenders to administer.¹⁹⁶ For example, JPMorgan Chase, the largest PPP lender, set a \$1,000 minimum on its loans,¹⁹⁷ so even if these small businesses had a relationship with JPMorgan Chase, they would not be able to receive PPP funding from the bank. There is a need for lenders for small businesses and sole proprietors that provide important community services but face difficulties obtaining loans.¹⁹⁸ Incentivizing online lenders to fill this gap, by providing a “Community Investment Certification” for lenders who provide a substantial number of businesses in “Investment Areas” most in need of this funding, can help these businesses survive a recession.

Certification will open opportunities for online lenders to receive additional funding from government awards or from private investors who seek to support community investment, while encouraging the provision of loans to those most in need, including small business owners and sole proprietors in minority and low-income communities. Certification can also be contingent on submitting a business plan that demonstrates that the lender intends to maintain an adequate level of capital to ensure cash flow during an economic downturn, which ensures borrowers have consistent access to credit.

3. The Subsidy Lock Mechanism Can Be Used To Require Online Lenders To Maintain Capital and Liquidity Requirements in Exchange for Federal Grants

Online lenders that lend to small businesses are vulnerable during an economic downturn because small businesses tend to face more obstacles repaying loans during

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *See supra* Part II.

an economic downturn.¹⁹⁹ Online lenders to minority business owners can counterbalance some of these economic pressures by maintaining adequate capital reserves.

Once an entity receives CDFI certification, it is eligible for both financial and technical assistance. In 2020, the CDFI Program awarded financial assistance in amounts of up to one million dollars, which were required to be matched with funds from a non-federal source.²⁰⁰ Financial assistance awards granted by the CDFI program can be used for lending capital, loan loss reserves, capital reserves, financial services, and development services.²⁰¹ Recipients may only use federal funds and matching funds for eligible activities pursuant to a formal agreement between the CDFI and a Recipient.²⁰² With respect to businesses, eligible activities include supporting businesses that: “(1) Provide jobs for Low-Income persons; (2) Are owned by Low-Income persons; or (3) Increase the availability of products and services to Low-Income persons[.]”²⁰³ In 2020, 230 CDFIs received awards, totaling \$127 million.²⁰⁴

Under this proposed CDFI-like system, an online lender that receives a “Community Investment Certification” can apply for federal grants. As a condition of receipt, the lender can be required to (1) match the funds dollar-for-dollar with funding from a non-federal source, and (2) maintain a certain level of loan loss reserves or capital reserves to ensure borrowers from the “Investment Area” can access credit during an economic downturn. The matching requirement

¹⁹⁹ See *supra* Section III.B.ii (discussing how Kabbage and OnDeck stopped originating loans during the COVID-19 pandemic).

²⁰⁰ CDFI FUND, CDFI PROGRAM AWARD BOOK 2, FY 2020 (2020), https://www.cdfifund.gov/sites/cdfi/files/documents/draft-2020-cdfi-fa-ta-award-book-091820_vapproval2.pdf [https://perma.cc/Q4W6-XXWX]. Funds must be matched dollar-for-dollar, unless otherwise excepted. See 12 C.F.R. § 1805.500 (2021).

²⁰¹ CDFI FUND, *supra* note 200, at 2.

²⁰² 12 C.F.R. §§ 1805.302, 1805.104 (defining an “Assistance Agreement” as a “a formal agreement between the CDFI Fund and a Recipient”).

²⁰³ *Id.* § 1805.301

²⁰⁴ CDFI FUND, *supra* note 200, at 4.

doubles the amount of money that will be invested in the community. The capital reserve requirement ensures that borrowers have a reliable source of credit, lessening the chance that small businesses will have to shut down from being unable to repay a loan if they face unexpected losses. In considering what level of reserves is adequate, the language of the OCC's special purpose national bank charter provides a useful guideline: an online lender that receives federal grants can be required to maintain minimum levels of liquidity proportionate to the risk of their lending activities.

A CDFI-like program that certifies and offers federal funding to online lenders for substantial lending to "Investment Areas" and requires such lenders to maintain a minimum level of capital reserves would allow more small businesses in low-income areas to access credit in both regular times and in recessions. Minority-owned small businesses, which are disproportionately located in low-income communities, would greatly benefit from such a program.

There are limitations to the effectiveness of such a program, however. One concern is whether online lenders would choose to participate in such a program. Lenders may fear that they will incur losses from maintaining additional capital reserves. To avoid losses, the investment a lender gains from being certified, either from private investors or the government, should make up for their costs in maintaining additional capital reserves. Certification would help online lenders attract investment from socially conscious investors,²⁰⁵ to balance out the costs of compliance and prevent lenders from incurring a net loss.

This proposed program could help minority small businesses in low-income communities survive economic losses without having to close down. Yet it is not a complete solution to the problem of lack of access to credit for minority entrepreneurs. Increased online lending would not bring minority business owners into the banking system or provide them with the stability of a banking relationship. A CDFI-like

²⁰⁵ *Eldar, supra* note 72, at 955–56 (discussing how a certification can attract subsidies).

subsidy system would leverage fintech to increase access to credit for minority entrepreneurs but it cannot serve as a complete replacement for a comprehensive banking system that provides access to credit across low-income and minority communities.

V. CONCLUSION

Minority business owners face challenges obtaining credit due to banking industry trends moving away from small-dollar loans, and because many minority entrepreneurs have limited credit data. Online lenders increase financial inclusion by providing credit to small business owners who do not have enough financial data to obtain loans from large banks. But small business borrowers who rely on online lending may face difficulties obtaining loans when they need it most—online lenders are more likely than banks to experience liquidity problems during a recession, in part due to their business models.²⁰⁶

Online lenders can avoid or reduce liquidity problems by maintaining a minimum level of capital reserves. A CDFI-like program could provide subsidies to online lenders that lend to small businesses in low-income communities while also requiring that those lenders maintain a certain level of capital reserves. Such a program could provide minority small business owners with a consistent source of affordable credit.

²⁰⁶ *Supra* Section III.B.ii.