***The Consumer Finance Podcast* – From Banks to Fintech: The Evolution of Small Business Lending (Crossover Episode With *Payments Pros – The Payments Law Podcast*)**
Hosts: Jason Cover and Carlin McCrory
Guest: Caleb Rosenberg
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Jason Cover:

Welcome to *The Consumer Finance Podcast*. This is Jason Cover, a host of the *Payments Pros* podcast, and this week we're airing a special crossover episode with the *Payments Pros*, also hosted by Keith Burnett and Carlin McCrory.

You're going to hear Carlin discussing merchant cash advance-related products, and the impact of recent legislation in Texas with Caleb Rosenberg and myself.

So, stay tuned, and I hope you enjoy the episode.

Carlin McCrory:

Welcome to another episode of *Payments Pros*, a Troutman Pepper Locke Podcast, focusing on the highly regulated and ever-evolving payment processing industry. This podcast features insights from members of our FinTech and payments practice, as well as guest commentary from business leaders and regulatory experts in the payments industry. I'm Carlin McCrory, one of the hosts of the podcast.

Before we jump into today's episode, let me remind you to visit and subscribe to our blog, TroutmanFinancialServices.com. And don't forget to check out our other podcasts on Troutman.com/Podcasts. We have episodes that focus on trends that drive enforcement activity, digital assets, consumer financial services, and more. Make sure to subscribe to hear the latest episodes.

Carlin McCrory:

Today, I'm joined by my colleagues Caleb Rosenberg and Jason Cover to discuss the transformation of small business financing including the emergence of diverse products and providers that have expanded access to funding. We will also discuss the evolving regulatory landscape including new state-level requirements and potential legislative impacts on financing practices. Jason and Caleb, I'm looking forward to our conversation today.

Jason Cover:

Thanks, Carlin.

Carlin McCrory:

So, Jason, could you tell us a little bit about the history of small business financing and the various products on the market?

Jason Cover:

Carlin, I think we've really experienced or observed an explosion in small business lending and financing over the last 10 or 15 years. I think traditionally, it was an area primarily served by banks, and with that in mind, primarily served to larger small businesses. If you were a startup, like a FinTech startup, for example, it may have been hard to find financing from a lot of the readily available creditors 10, 15, 20 years ago. I think this has largely corresponded much with the online lending industry and the FinTech lending industry that we've seen on the consumer side, and that traditional banks haven't really been able or aren't willing to serve many of these types of businesses, just like they weren't able to serve many of the consumers that needed smaller loans, and FinTech opportunities and online opportunities have really filled that gap.

I guess, primarily, we see several different forms of small business financing. They can be anything from a loan, which is substantially similar to what we all know from a consumer lending standpoint, whether it's an installment loan or an open-end loan or variations in between. And then we also see traditional factoring arrangements and also merchant cash advance. On those two, just to sort of eliminate some confusion because I think folks get these confused a bit. But when we say factoring, we typically mean that the factor that the company purchasing an assignment of existing receivables, right?

So, you actually take assignment of the receivables, whereas merchant cash advance we typically think of as one or more cash advances that are going to be repaid from future receiver bowls. The MCA in particular, I think, would be interesting for folks that are involved in the payments industry because those products have the advantage of being underwritten largely based on the business's cash flow instead of traditional credit underwriting.

So, we see a lot of clients that offer MCA either partner with payment processors or even some payment processors offer these products because they already have the insight into those payments that are coming through as the receivables are generated. Then the other interesting thing that we've observed is that as these products have grown up and become more complex, the business model or regulatory environment has also become more complex. Caleb's going to talk a little bit more about that, I think, but essentially, in the early stages, we saw a lot of creditors or finance companies that used just a choice-of-law model. They'd pick a very advantageous state like Utah that largely deregulates interests, and they'd say, “Hey, this agreement is governed by the law of Utah. We have a bunch of contacts there, and therefore, we'll make this loan pursuant to Utah law.”

I think as some companies grown up, and as the regulatory environment grew up, they started, like many of our consumer-licensed lenders, started working on a case-by-case, state-by-state basis and trying to conform more to those laws. Then even more recently, now we see, many of these small business lending programs have moved to partnering with banks like many of the other, many of our consumer FinTech clients.

Caleb Rosenberg:

Jason, I completely agree with that. I think we've seen both the maturation of the industry players paying attention to state laws that were always applicable to their products, like licensed lending laws for traditional lenders, usury rates for traditional lenders, and really drilling down into whether that choice of law model works in every state, and at the same time, I've seen regulators and state legislatures paying much more attention to it, and those two kinds of go hand in hand.

On the state legislative side, we've seen what we like to call the consumerization of small business lending, a number of states. I think it's nine states with effective laws now, and three more that have passed in various stages of the legislative process have passed laws that are applying consumer-like disclosures to small business lending. There's some differences between them, but it's really forced companies in this space to pay attention to the differences at the state level and provide more disclosure to borrowers, and in the case of MCA, to non-credit products as well.

The most recent of these that we're watching very closely is out of Texas. There's a bill that was passed through the legislature is sitting on the governor's desk. Like many of the state disclosure laws, the disclosure aspects of it are not particularly burdensome and are something that you have to pay attention to on a state-by-state basis, but are not something that would significantly change a business model. Texas also has registration that we've seen in a couple of those nine states as well, similarly would not change a business model. Texas has a single provision that is causing the industry to reconsider how they're going to offer products in Texas. The provision requires a perfected security interest in a deposit account to have automatic payments drawn from that account. That makes it almost prohibitive for a company to have automatic payments drawn from an account because to perfect a security interest in a deposit account, you need an agreement between not only the finance company and the small business, but between the finance company, the business, and the bank.

For short-term transactions that many of these are, it's an operational issue to have that agreement put into place. And is causing companies to significantly reconsider how they might go about offering these products in Texas. For payment processors, I think one of the interesting solutions is not having payments drawn from the small businesses deposit account, but instead having an agreement with the small businesses payment processor to split the payments at the processor level so that the amount owed to the finance company never goes into the small businesses, deposit account, and so there would be no payments being drawn at all.

I think that many in the industry would prefer to the governor just not sign the bill, but I don't think that we have control over that specific aspect of it. So, we're all kind of sitting at the edge of our seats waiting to see if this gets signed in the next couple of weeks.

Carlin McCrory:

Caleb, other than the potential workaround for payment processors that you just mentioned. If this is passed, do you suspect that companies may just not offer the products in Texas? Or how do you think this could impact the industry?

Caleb Rosenberg:

I think there'll be a significant impact. I think another solution that Jason alluded to as going back to the old models of companies offering a traditional lending product using a choice of law model, Texas traditionally has had pretty good law in that area, that if a company is appropriately set up, it has strong contacts with another state that has relatively unregulated or permissive lending statutes. That's another option that companies might consider. But either model the kind of split processing model or traditional lending from another state requires some planning and putting things into place and cannot just be flipped on with the switch. So, I think it's something that companies are going to be spending some time on.

Jason Cover:

Very much agree with Caleb. I think what we've seen is the last-minute scramble here while this legislation is pending to try to find solutions. And to Caleb's appointment, many of our clients, I think, have looked to some of the other models, but it does take time. I think the rough estimate, for example, to get a bank program up and running if you don't already have one could be anywhere from six months to a year. So, it's not necessarily something that can be turned on immediately once this law does or does not go into effect.

Carlin McCrory:

Thanks, Jason, for that insight. It's my understanding that Louisiana also enacted a new disclosure law this month. Do we expect any sort of similar impact from the Louisiana law?

Jason Cover:

I think the impact is not the same as Texas' in the sense that it would cause the industry to shift their product structure withdrawal from the state. It is another example of the disclosure regimes that we've seen in other states like California, and it applies to all revenue-based financing products. Your MCAs and the like will get caught in the disclosure regimes. They arguably don't make a heck of a lot of sense for something like that, but be that as it may, it seems to be the modern trend. I would say that one other notable exception to the Louisiana law is it doesn't have any specific product or financier exception. So, we often see exceptions for banks or exceptions for advances over a certain amount, or lines above a certain amount, or things of that nature in these statutes. And Louisiana just not have that.

Carlin McCrory:

Caleb and Jason, are there any best practices for offering these products? Obviously, state-specific disclosures require analysis, but are there common things that the companies get tripped up on or things that they should be cognizant of?

Caleb Rosenberg:

I would say just making sure that your servicing matches what your product structure is. I think for a long time, we saw companies try to paper their transactions as if they're non-loans, but then service them as if they are lending products. And I think that changed over the last five or six years and companies are now much better at servicing the products kind of along the terms that they should have that are consistent with their contracts. So, I would just encourage companies to think about the servicing and advertising sides of it beyond just what's written on a piece of paper, because that's also evolved in the last several years too.

Jason Cover:

One of the primary risks, particularly for MCA would be re-characterization as a loan, right? So, when you're papering it, you want it to look like MCA and not a loan necessarily. So, you’re trying to, or factoring would have the same risk. That becomes very important in understanding those risks, maybe even on a state-by-state basis, which can be, I think, frustrating for both us and our clients because in a, for example, a consumer lending scenario is very easy to say, “Hey, you need this license, and you can't exceed this rate in this state,” then that's in a statute where it can be a little bit more art and science sometimes to identify the exact risk in any given state to a product that doesn't neatly fit in that credit bucket. But understanding that risk is important, and structuring a product appropriately is as well.

Carlin McCrory:

And do you both have any additional thoughts on the future of these products? I mean, do you all expect additional state laws potentially to be issued in the future? I know it's all speculation, but we'd love to hear your thoughts on what you expect the future to look like.

Caleb Rosenberg:

Yes. I think that right now we've seen both several liberal states pass laws that are target these products, and also several conservative states that pass somewhat easier to comply with laws that target these products. There are numerous states that have not taken action in any way yet. The fact that we've seen action from both kind of the highly regulated states and the more lightly regulated states suggests to me that most states eventually will get around to passing similar laws and that it's just a matter of time. So, I expected to be more legislative action and just more regulatory scrutiny.

I think AGs in particular coming to the defense of small businesses, an easy thing for them to get behind and to set some announcements up that are politically friendly across the board. So, I think that we can extract more regulatory scrutiny in this area.

Jason Cover:

Very much agree with Caleb. Carlin, you're very familiar with like the EWA landscape, and it's somewhat reminiscent of EWA light as these products have exploded in popularity, much like EWA seems that the state legislatures and AGs and regulators have taken notice and are increasingly legislating rules about them and regulating them. So, it's something to monitor, I think, if you're in the industry or working with folks in the industry.

One other note I would have that I think is often missed is the FTC technically isn't just a consumer trade regulation group. It has oversight on small businesses. So, there is a federal regulator in play as well. There was recently a consent order. In general context, not exactly MCA or the like, but the FTC is someone to observe in this area as well and pay attention to.

Carlin McCrory:

Well, Caleb and Jason, thank you for joining me today. And thank you to our audience for listening to today's episode. Don't forget to visit our blog, TroutmanFinancialServices.com, and subscribe so you can get the latest updates. Please make sure to also subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you use. We look forward to next time.