FinRegLab

FACT SHEET: CASH-FLOW DATA IN UNDERWRITING SMALL BUSINESS LOANS

Data Is Being Used by Both New Entrants and Traditional Lenders to Extend Smaller Loans to Smaller Businesses and Increase Credit to Underserved Borrowers

Small businesses are the cornerstone of the U.S. economy, creating two out of every three net new jobs in the U.S. in the past fifteen years. But several factors make them relatively difficult and expensive to underwrite compared to consumers and larger companies. Businesses owned by racial minorities, recent immigrants, and women face particular challenges in accessing credit.

Cash-flow data—such as companies' bank account records, feeds from their accounting software, and transaction information from e-commerce platforms and payment processors—is one of the most promising options for automating small business underwriting because it provides a more detailed and timely picture of how applicants manage their finances than traditional credit reports. Such information is also becoming increasingly easy to access electronically.

FinRegLab has published a report detailing the growing use of cash-flow data in the small business lending market and examining policy and market issues that may shape its further expansion. The report, *The Use of Cash-Flow Data in Underwriting Credit: Small Business Spotlight,* can be found here. It follows on an independent empirical study that FinRegLab published earlier this summer evaluating cash-flow variables and scores used by six non-bank financial services providers, including two companies that serve small businesses markets.

The Spotlight report finds that the use of cash-flow data appears to be spreading more rapidly in small business lending than in consumer lending. Specifically:

- **Cash-flow data is valuable to lenders because it provides a more detailed, timely picture of small businesses' income flows and cash reserves than traditional credit history information.** Lenders have traditionally collected bank statements, cash-flow analyses, and other annual financial reports to help analyze the health of business applicants. But obtaining detailed electronic records allows lenders to engage in faster, more sophisticated, and more consistent analysis. The information is useful for established small businesses, but is even more valuable for startups and business owners who don't have strong traditional credit histories.

- **Use of cash-flow data is spreading across a diverse range of credit providers.** Use of electronic cash-flow data was pioneered by marketplace lenders after the 2008 financial crisis, but has spread over the last decade. For example, a number of banks have begun analyzing their existing customers' deposit data to facilitate faster underwriting. And payment processors, e-commerce platforms, and accounting software providers have begun using cash-flow data from their primary business operations to provide loans to small businesses.

- **Further growth may depend on a number of market and policy issues.** Stakeholders identified several issues that may affect further growth, as well as important considerations about how to mitigate risks and encourage the spread of practices that benefit small business owners. Such issues include:

    - **Providing greater transparency to small business applicants** about how cash-flow data may affect their credit applications, any monitoring of cash-flow data as loans are being repaid, and the benefits and risks of authorizing cash-flow data to be transferred between companies to facilitate the underwriting process.
    - **Addressing privacy and security concerns about transfers and use of cash-flow data.** Research suggests that small business owners are concerned about privacy and confidentiality of their data in much the same way as consumers are. Privacy concerns may be heightened where owners use the same accounts for personal and business transactions.
    - **Reducing technology hurdles and cost considerations for smaller traditional lenders.** Although community banks have played a special role in small business lending historically, they face special resource challenges in establishing cost-efficient electronic feeds of cash-flow data, validating new underwriting algorithms, and vetting vendors in accordance with federal regulatory guidance.
    - **Further public research on the predictiveness, inclusion, and fair lending effects of cash-flow data would be useful.** Given the technology and business process challenges in developing cash-flow algorithms, more public research would be useful to help lenders make resource decisions, facilitate the development of securitization markets, and address concerns that underwriting models have not been tested through a full business cycle.

A forthcoming FinRegLab report will provide broader market context and policy analysis that bridges across consumer and small business markets. In particular, the report will provide a detailed description of market, legal, and policy issues raised by cash-flow based underwriting and by the underlying transfers of data between companies for credit and other purposes. The report builds on three working groups that FinRegLab convened in late 2018 to solicit insight and opinion from more than 80 representatives of fintech companies, banks, data aggregators, advocacy organizations, and research institutions.

FinRegLab's earlier report was based on data from a range of non-bank financial services providers—Accion, Brigit, Kabbage, LendUp, Oportun, and Petal—that have begun using cash-flow variables and scores in an effort to provide unsecured credit to consumers and small businesses who may have difficulty obtaining loans from traditional sources. FinRegLab retained Charles River Associates to help design and conduct an independent analysis of the predictiveness of the participants' cash-flow variables and scores based on actual loan performance.