ELECTRONIC TRANSACTIONS ASSOCIATION

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January 22, 2018

Commissioner Jan Lynn Owen
Department of Business Oversight
1515 K Street
Suite 200
Sacramento, California 95814

RE: Commercial Financing Disclosure – PRI 01-18

Dear Commissioner Owen:

On behalf of the Electronic Transactions Association ("ETA"), we appreciate the opportunity to share our thoughts regarding commercial financing disclosure. ETA supports transparency in small business financing disclosures, including providing borrowers with the best information to compare costs across products and make informed decisions. ETA supports a competitive marketplace for small business financing with fair, transparent, and readily understandable financing options. Good public policy on this issue dictates that disclosures allow for small businesses to be able to accurately compare total costs across products.

ETA is the leading trade association for the payments industry, representing over 500 companies that offer electronic transaction processing products and services, including financial institutions, transaction processors, payments networks, and others. ETA also has members that are engaged in online lending for commercial enterprises, primarily small businesses, either directly or in partnership with other lenders.

<u>Overview of Online Small Business Financing Models</u>

Many online small business financing companies share several similarities that include:

- Providing borrowers with efficient access to credit that relies on existing data streams and automation, often providing funding decisions within 24 to 72 hours.
- Offering small loans with short-term maturities, often between 6-18 months.
- Using automated online loan applications (either with data they already have on the customer or data that the customer provides them) and have no retail branches.
- Utilizing electronic data sources and technology-enabled underwriting models to automate processes such as determining a borrower's identity or credit risk. The data sources used include traditional underwriting inputs, but also real-time business accounting, payment and sales history, online small business customer reviews, and other non-traditional or alternative data. [1]

[1] *See* U.S. Department of Treasury, *Opportunities and Challenges in Online Marketplace Lending*, p.5 (May 10, 2016).

While online small business lenders have many different types of business models, two major business models have emerged.

The first type of primary business model for online small business lenders is as a direct lender and, where applicable, as a state licensed lender in those states requiring licenses. In such states, direct lenders originate loans on their own books and may be required to obtain licenses or register with the individual states in which they lend. These direct lenders do not rely on depository institutions to originate loans, but rather make loans themselves and either hold those loans in their own portfolios and rely on capital sources including credit facilities, whole loan sales, and securitizations to fund their originations.

The second type of primary business model for online small business lenders is the bank partnership or lending platform model. Lending platforms provide services for an issuing depository institution to process loans and then purchase the loans to hold on their books or for sale to investors as whole loans or by issuing securities such as member-dependent notes. In this model, the issuing depository institution originates loans to borrowers that apply on the online platform. The loans are subsequently held by the issuing depository institution for a period of time (typically 1-21 days) and then purchased by the lending platform or directly by an investor through the platform.

Under this model, lending platforms are not the lender because they do not originate the loans. Rather lending platforms are technology or outsource vendors rather than the actual lender. The issuing depository institution, expressed as a lender in the borrower's contract, is expected by its banking regulator to oversee the lending platform as a vendor. An online lending platform that meets the statutory definition of a bank service company or a third-party service provider to one or more depository institutions may also be subject to the regulation and examination authority of the relevant federal banking agencies under the Bank Service Company Act. [2]

As the market develops and becomes more mature, both direct lenders and lending platforms are altering these frameworks to allow more flexibility to provide credit to small businesses. Some direct lenders have developed hybrid models, selling some whole loans to institutional investors while retaining servicing responsibilities. The combination of data-driven underwriting, automated and online operations, a lack of legacy systems, and investor capital has allowed online small business lenders to make third-party arrangements to fill a need in the small business lending market.

Referral Partners

Referral partners may perform a variety of services, including assisting borrowers to identify potential financing options, generating leads for lenders, and in some cases, assisting in the application process. There are a few types of referral partner business models in the market today, but the common thread among referral partners is that they do not make credit decisions on credit applications.

[2] 12 U.S.C. §§ 1861-1867.

One prominent referral partner model is the marketplace matchmaking platform model. Marketplace platforms provide a portal where small businesses can go to use the resources and partnerships of the referral partner to help small businesses with certain aspects of getting commercial financing. In many cases, the small business fills out (or at times, the company pre-fills on the small business's behalf by using data from their financial management software) an application and is given a choice of tailored financing available from a variety of financiers. The credit decisions and financing are made by independent, third party financiers including traditional lenders, online lenders, companies that purchase future receivables and SBA-approved lenders. Those participating financiers may offer term loans, SBA loans, lines of credit, purchasing of future account receivables, invoice financing and small business credit cards. The criteria are established by the participating financier on the platform to give a small business a clear understanding of the range of financing options available to them. The small business chooses its preferred choice of financing product and financier and the platform forwards the application information to the financier. The financier makes the credit decision on the application.

Marketplace platforms often serve as highly valuable price and product comparison tools for small businesses. Marketplace platforms play a key role in helping to match small businesses and their individual credit needs to financier that can provide products which meet those credit needs.

Overview of Online Small Business Financing Products

The online small business financing market provides access to capital for small businesses by providing a variety of financing options. Small business financing products include fixed term loans, open-ended lines of credit, revenue-based loans, and the purchase of future accounts receivables.

Term Loans

Traditional term loans are relatively straight forward contracts. With a term loan, a small business borrows a lump sum of money, gets it all at once and pays it back over a specific time period (term). Small businesses can select term loans with different repayment periods and with a fixed rate or variable interest rates to best suit a small business's cash flow needs.

Term loans typically specify a maturity and an interest rate. Such a product has the advantage of simplicity, with pre-specified fixed monthly, weekly, or daily payments that follows a schedule and is constant over time. The monthly, weekly, or daily payments are a direct function of the loans amount, flat fee, interest rate, and loan maturity. Many of the characteristic of term loans make them the easiest to calculate annualized metrics because they have set terms, interest rates, and amounts.

Lines of Credit

Like a term loan, a line of credit provides a business with access to capital. However, unlike a term loan, there's no lump-sum disbursement made at account opening that requires a subsequent

monthly payment.

A line of credit is revolving credit. Interest begins to accumulate once you draw funds, and the amount that is paid (except for interest) is again available to be borrowed as the balance is paid down. A line of credit can be drawn on it up to a maximum amount for a set period of time.

Business lines of credit with lower credit limits are typically unsecured, which means collateral such as real estate or inventory is not required.

Unlike a term loan which has set characteristics like a set term, loan amount and repayment amounts, in order to provide a total amount of funds provided, total cost of financing, and ultimately an annualized disclosure metric, a number of assumptions must be made with respect to a line of credit such as how much and when the line of credit is drawn down as well as how much of that amount is paid back and when. To calculate and disclose such total cost metrics, the providers of open-end credit plans must make assumptions about the amount (s) that will be drawn on the line of credit. These assumptions my not be borne out or ultimately reflect the actual costs accruing to the borrower.

For example, in order to provide the total dollar costs of financing and ultimately an annualized disclosure metric, the provider must assume some draw amount. An open-end credit plan can be utilized by a borrower in different ways, and the amount of money drawn and the length of time such money is held will impact the cost. If the provider is asked to discloser the dollar amount of interest a borrower will pay, the provider must assume a draw amount to provide that information. All of those assumptions can affect the cost and ultimately the annualized rate disclosure and may not represent the true and accurate cost paid by a small business.

Revenue-Based Loans

A revenue-based loan is a hybrid product which shares traits with both loans and accounts receivable transactions.

A revenue-based loan specifies (1) a total cost: the dollar amount paid to the lender in excess of the principal and (2) a repayment rate: the lender receives a fixed fraction of all the sales made by the borrower until the loan total cost has been repaid. The distinguishing characteristic of a revenue-based loan is that there is no fixed schedule payment amount or term. When the business makes a sale, a percentage of the transaction is paid to the lender. This continues until the total amount of the revenue-based loan has been paid. By scaling the repayments to the businesses' sales, revenue-based loans allow for significant risk-sharing between borrowers (small businesses which are typically risk averse, financially constrained and exposed to firm-specific risk) and lenders (a larger institution with more risk-bearing capacity). This is especially beneficial for businesses with more volatile sales, as payments to the lender get automatically reduced when sales are low.

The maturity of a revenue-based loan depends on how much sales the business generates. For example, larger sales will lead to a shorter maturity as the firm will work more quickly towards

loan repayment. Unlike a term loan which has set characteristics, in order to provide an annualized disclosure metric on a revenue-based loan, certain assumptions must be made about the future sales of the business to determine when the loan will be paid back. Those assumptions can affect the ultimate annualized rate disclosure and may not accurately represent the cost of the loan.

Purchase of Future Account Receivables

The purchasing of future account receivables are not loans, but rather, they are a sale of a portion of the small businesses' future credit and/or debit card receivables. Companies that provide funds to businesses in exchange for purchasing a percentage of the businesses' future daily credit card sales, are paid from the customer's daily debit and credit card sales, until the obligation has been met. Many purchasers form partnerships with payment processors and take a percentage of a merchant's future credit card sales.

The distinguishing characteristic of a purchase of account receivables is that there is no fixed scheduled payment amount or term. When the merchant makes a sale via credit and/or debit card, a percentage of the transaction is forwarded to the purchaser. This continues until the total amount of purchased receivables has been paid. The financing company receives the purchased receivables in one of the following ways: (i) the merchant's processor forwards the purchased receivables directly to the funder; (ii) the merchant's receivables are deposited into a lockbox account that forwards the purchased receivables to the provider and remits the balance to the merchant; or (iii) the provider is notified of the amount of the credit card receivables generated and the funder debits the purchased portion from the merchant's business bank account.

For many small businesses, the purchase of future account receivables is an alternative to a traditional commercial loan because the transaction does not require personal guarantees from the business owner only a performance guaranty. The performance guaranty requires that the owner ensure that the business entity complies with the terms and conditions of the purchasing agreement. Moreover, unlike a commercial loan which has an absolute right to repay, in the event a business closes, and does not breach the agreement, the business is not held responsible to pay the remaining balance on the agreement. The purchaser takes a risk that a business may close. For example, when California was plagued by wildfires, any small business that had to close its doors due to the wildfires, would not be obligated to pay the outstanding balance on the agreement because the business closed, without breaching the contract, as the purchaser assumed the risk in purchasing the future account receivables.

Small Business Lending Is Different Than Consumer Lending

It is imperative that policymakers not conflate consumer lending with small business lending. Commercial and consumer credit are distinctly different types of credit. Small business borrowers have different needs and objectives in obtaining credit than consumers – often relying on financing to buy inventory, smooth cashflow, and expand their marketing. Small businesses are the backbone of the economy and providing them with that financing enables them to continue to grow. Small business lenders have developed credit products specifically designed to answer those needs and objectives. For example, the length of a small business loan is often measured in months rather

than years. ETA cautions that an approach that would simply apply existing requirements for consumer lending to small business loans would have detrimental effects for both online small business lenders and the small business community. Particularly, because ETA member small business lenders are providing access to credit to businesses that are traditionally underserved and unable to access financing through more conventional means.

Many of ETA's members provide financing to their customers that average less than $25,000. Small businesses often are looking for small amounts to get them through a period of time (i.e., to cover payroll or smooth out a bumpy cash flow) or to fund a specific activity (i.e., a new marketing campaign). ETA supports a system that provides small business borrowers with fair, transparent, and readily understandable disclosures that are comparable across products.

Annual Percentage Rate (APR)

Providing an APR disclosure includes a number of challenges for both small business financing companies and small businesses themselves. If DBO was to use APR as the metric of choice, one of the fundamental questions that would need to be answered is whether the APR calculations methodologies in Regulation Z would be used or if some other set of assumptions and calculations is drafted.

Challenges with using APR

- Whether the DBO uses Regulation Z as a model or references to it directly when mandating APR could have significant effects on disclosure requirements. There are certainly benefits to having a well-tested regime such as Regulation Z to use, however many of the types of products that fall under the California law were not contemplated by Regulation Z. Neither the Federal Government nor any state before this law have ever mandated or applied an APR disclosure to the purchasing of account receivable or revenue based-loans because there is no fixed repayment term, most models do not include fixed daily payments, and for some products there is no absolute right to repay.

- Mandating the calculation of APR under Regulation Z in a commercial setting would result in different calculations depending on the product, even if the overall repayment amount is the same. For example, Regulation Z does not contemplate daily pay loans. How would weekend and bank holidays be addressed? Some lenders skip those days and others require make up payments. If lenders address these issues differently, it will result in different APRs for the exact same product, even when the total dollar cost of credit is the same. This could cause confusion to small business by imposing an APR disclosure on a product that was never contemplated to be covered by Regulation Z and that would result in misleading APRs.

- The law does not specify the form in which APR should be disclosed. Regulation Z specifically mandates that the APR disclosure be accurate with 1/8 of 1 percentage point. 12 C.F.R. 1026.22(a)(2). For irregular loans, which are offered by some of the ETA members, it requires 1/4 of 1 percentage point. This would require the APR to be disclosed

at least to one decimal point in many circumstances.

- The law does not address any tolerance limits for APR calculation errors. Regulation Z has specific rules for APR calculation errors and provides a threshold in which an APR is deemed accurate. However, an APR that falls above that threshold is a violation. Given that many of the types of products that fall under the California law were not contemplated by TILA, this represents a significant challenge.

- APR calculations are highly duration-sensitive for loan terms of less than a year. In other words, the APR increases rapidly the shorter the loan term. For example, the APR of typical short-term commercial loans will fluctuate widely based on only small differences in the term of the loans. This can be misleading when comparing short term small business financing products with longer term financing products. This could steer small businesses to financing products with a longer maturity time then they want.

- Similarly, certain commercial finance products, such as revenue-based loans and the purchasing of future account receivables have a fixed cost but no fixed term and are paid through a set percentage of the small business' future sales or account receivables. Solely focusing on the effective APR of such transactions would not tell the whole story because, if the business has higher sales than expected and repays the revenue-based loan faster than anticipated or delivers the purchased receivables faster than anticipated, the duration of the transaction decreases and the effective APR increases.

Annualized Cost of Capital

The use of Annualized Cost of Capital (ACC) is a different metric that APR but has several challenges that are significant. ACC is a new untested metric. If ACC was required for commercial financing, such a disclosure has the potential to make disclosure confusing and less useful for small businesses for many reasons, including the following:

- This is a new metric, which is not easily understood, nor has it been tested with small businesses. This metric is not required to be disclosed in any other states or federally. This new metric is likely to confuse small businesses.

- Neither the Federal Government nor any state have ever mandated, recognized nor applied an estimated annualized total costs of capital disclosure to revenue-based loans or the purchasing of account receivables because there is no fixed repayment term, most models do not include fixed daily payments, and there is no absolute right to repay for the purchase of account receivables.

- We are unaware of any studies or analyses that have been conducted by any objective third party to evaluate whether ACC yields accurate or comparable results across multiple financial products.

- ACC is likely to cause confusion among lenders in California, as it lacks the detailed

framework necessary to calculate it consistently and accurately, and this confusion will undoubtedly be shared by borrowers. Certain commercial finance products available to California's small business customers today, such as revenue-based loans and the purchasing of future account receivables which have no fixed terms or lines of credit which must include several significant assumptions, and therefore, are unable to accurately reflect the actual cost of capital under ACC.

Definition of Provider

How will partnerships between depository institutions and non-depository institutions be treated under this definition? What does it mean to "administer" an online lending platform and will DBO be providing any clarity or guidance on this point?

As noted, depository institutions increasingly are entering these types of relationships with online platforms to expand their ability to efficiently offer small business loans to their customers. However, if, as a result of the sum of these services, the online lending platform is deemed to be "administered by" the non-depository institutions, such transactions will be subject to the disclosure requirements of SB 1235 despite being made or /originated by depository institutions. This determination is potentially confusing given that depository institutions are expressly exempted from the disclosure requirements under Section 22801(a) of SB 1235. We are concerned that the phrase "administered by" is overly ambiguous and could be interpreted to cover a broad range of non-depository entities that function simply as service providers or vendors to exempt deposit taking federal or state bank lenders.

We respectfully request that the DBO provide guidance and clarity on what collections of services will cause an online lending platform to be deemed to be "administered by" the non-depository institutions. We recommend guidance to narrow the definition of "provider" to exclude a non-depository institution that acts as a service provider in support of a depository institution's small business financing program and is subject to supervision and examination by the depository institution's federal regulator.

Lines of Credit

The formation of annualized rate in the bill is problematic for revolving products. In order to provide the disclosures required by 22802(b)(1), (2), (4) and (6) for revolving products or open-end credit plans, assumptions must be made regarding the draw amount and the time such funds are held. ETA requests that DBO provide additional clarity on these issues.

Timing of Disclosures

The disclosures must be provided at the time offer for credit is extended. This presents a challenge for automated offerings to provide the disclosures and obtain a signature at point-of-sale. Additional guidance is likely needed on this point to provide clarity for the industry on how this would be applied to automated systems or how brokers would fit into this disclosure regime.

For brokers, there is a specific clarification needed around the actual timing of disclosures, and if the disclosure is triggered only when a firm offer of credit is presented to the customer (as opposed to a response to a pre-qualification or preliminary inquiry). It is ultimately the lender's responsibility to provide the disclosure when presenting a firm offer to customers.

Signature Requirement

Section 22802 (a) requires that a provider disclose all the required information to a recipient at the time of extending an offer to that recipient and shall obtain the recipient's signature on such a disclosure before consuming the commercial financing transaction.

It is unclear whether, if a borrower signs an agreement and the required disclosures are included within the agreement, that is sufficient to meet the requirements of the law?

ETA respectfully requests that DBO provide additional guidance on this issue which allows for the disclosure to be part of the loan agreement and that signature on the loan agreement would be sufficient. In the alternative, DBO may wish to provide guidance which allows for rending a signature on the screen and the affirmative act of a check box as an acceptable form or consent (in lieu of an actual or electronic signature).

Fees To Be Included In Calculation

When disclosing the total dollar cost of financing and when calculating an annualized metric, the law does not provide guidance as to what types of fees are to be included in that disclosure or calculation. A detailed list of fees including guidance on what constitutes those fees and how to calculate those fees, would be helpful for consistency in disclosure across the industry.

For example, under Regulation Z, an APR cannot be calculated without a determination as to what types of fees and charges are Finance Charges (a defined term under TILA). Finance charges are included in the APR calculation. Therefore, in order to calculate APR there must be clear guidance on what is or is not a Finance Charge. The California law does not state what fees should be considered Finance Charges.

Description of Prepayment Policies

The law in Sections 22802 and 22803 requires a description of prepayment policies. Additional guidance is needed as to what would constitute a sufficient description and the format such a description should take. As an example, additional fees that are required upon prepayment may be represented differently than interest payments still required when the capital and accrued interest has been paid.

Implementation Date

Given that significant changes that are required on the backend for implementation, would the DBO consider providing a minimum of 12 months to implement required changes after the final

regulations are released? That would ensure that companies would have enough time to make internal changes and work with vendors and other third parties to ensure a smooth implementation.

Enforcement and Supervision

Given that the law provides for DBO to have additional entities of which it has supervision and enforcement authority, would the Department consider providing guidance regarding what that would look like for providers that are not California licensed lenders?

Amount Threshold

Section 22800 (n) defines "Recipient" as a person who is presented a specific commercial financing offer by a provider that is equal to or less than $500,000.

The law has some ambiguity as to how to measure an open line of credit as it relates to the $500,000 threshold. Does the threshold apply to the total line of credit offered? Does it apply to amount drawn from the credit line?

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Thank you for the opportunity to participate in the discussion on this important issue. If you have any additional questions, you can contact me or ETA Senior Vice President, Scott Talbott at stalbott@electran.org.

Sincerely,

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