

January 19, 2019



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

RE: Comments on Proposed Rulemaking Commercial Financing Disclosures

Commissioner Owen,

The Small Business Finance Association (SBFA) is a non-profit advocacy organization dedicated to ensuring Main Street small businesses have access to the capital they need to grow and strengthen the economy. SBFA's mission is to educate policymakers and regulators about the technology-driven platforms emerging in the small business lending market and how our member companies bridge the small business capital gap using innovative financing solutions. SBFA is supported by companies committed to promoting small business owners' access to fair and responsible capital.

In principle, we support most of the disclosures required in SB 1235 and look forward to working with DBO on implementation. Our comments will focus on the disclosure of an annualized rate and the instruction SB 1235 provides DBO to choose a method to disclose an annualized rate. We strongly supported Senator Steve Glazer's effort, along with other members of the Senate and Assembly, to improve SB 1235 by replacing APR with a simpler rate disclosure known as Annualized Cost of Capital (ACC). The bill with ACC as the annualized metric passed the Senate on May 31, 2018, and was endorsed by a broad coalition including the California Small Business Association and the California Black Chamber of Commerce.

***ACC is simpler and easier for small business owners to calculate, providing more transparency so they can make better decisions for their companies.***

We believe ACC is a simpler, more efficient means to demonstrate the true cost of capital and compare products in a diverse marketplace. Not only does an ACC provide the small business owner with an easy-to-understand pricing guide, it is simple for both the lender and the merchant to calculate. The main concern cited by some opponents of the metric is that it is not "tested." We find that argument to be vague and insufficient. The simplicity of the calculation does not require testing, as it is finite math.

In the invitation to comment, DBO requested respondents to share which calculation they prefer between ACC and APR. As if it to demonstrate ACC's simplicity, DBO quoted the entire

calculation in one line:

*(Total Dollar Cost of Financing ÷ Total Amount of Funds Provided) × 365 ÷ (Term or Estimated Term) × 100*

In stark contrast, were DBO to quote the calculation for APR, it would require more than 30 pages of federal register to accomplish.

The simplicity of ACC allows merchants to calculate the cost of various products and terms while shopping for financing rather than wait for it to be disclosed to them. The ACC calculation allows merchants to easily compare costs of financing products that are daily, weekly, or monthly payback, including comparing fixed term loan products with open-ended credit, factoring, or advances.

ACC puts small business owners in control of their financing choices, enabling them to make sounder decisions that benefit their companies and, ultimately, the broader economy.

***Consumer and commercial finance products—and customers—are vastly different and should be regulated accordingly.***

We firmly believe that consumer and commercial financial products should be treated differently because they serve fundamentally different customers. This belief is consistent with decades of federal legislative history dating back to the 1960s when Congress intentionally excluded small business loans from the Truth in Lending Act (TILA). Small business owners are sophisticated customers who are motivated by business decisions. SBFA hears repeatedly from small businesses that speed and efficiency of capital, cash flow, and total cost of the products are main drivers—unlike individual consumers who are focused on different priorities.

While APR is a disclosure that consumer advocates argue should be included in every type of financing transaction, its usefulness in even consumer transactions has been questioned. In fact, in the recent comprehensive studies of APR, some federal regulators have recognized APR has caused confusion and is not even useful to the average consumer.

As mentioned above, in TILA there are pages of guidance on how to handle various consumer products and payment types and what assumptions should be made for various products as well as language shielding creditors from liability for minor calculation errors. California would be the first state to apply an annualized rate disclosure to commercial finance. We appreciate the state's leadership on fair and responsible lending and, in the spirit of being good partners, feel it is incumbent on us to raise challenges before they become the problem of small business owners. In the case of SB 1235, the exceptionally complicated nature of the issue will result in an expansive, impractical—and in some cases, impossible—scope that will undermine the intent of the law. To cover the many different products that companies offer small business customers will require going far beyond what is cited in TILA, creating a morass of additions

that will make for more ambiguity and complexity—directly opposing the legislation’s well-intended goal.

***APR is confusing to small business owners and distorts the price of financing products.***

During the legislative process it was clear the intention of SB 1235’s author, Sen. Glazer, was simply to provide small businesses a tool to compare the price of different financing products. We agree with and support that intent.

Through many public statements on the issue made by Sen. Glazer, APR disclosure was ultimately removed from SB 1235 and replaced by ACC, because APR does not accurately reflect the true cost of certain financing products. Specifically, in short-term financing products or products that require a daily payment, APR can make two financing products with the same terms and total payback have significantly different APRs. This variation is caused by the impact of the declining balance on a daily payment product has a compounding effect on APR making it seem more expensive than a weekly or even monthly product with the same payback.

Additionally, APR can distort the price of short-term products. Again, small businesses are different than individual consumers. Merchants are looking to use financing to make short-term investments in their businesses to increase growth and profit. Most often, a merchant has identified a key growth opportunity, needs to make repairs or replace equipment, or must purchase inventory. Our members structure the financing product’s term to correspond with the estimated investment payback period so the merchant can minimize the total overall interest expense. For instance, if a small business is purchasing inventory, the term of the financing product offered to the merchant typically will correspond with the sale of that inventory. In most cases, the merchant will pay less in total interest expense on a higher-rate, short-term financing product than on a lower-rate, long-term financing product.

As an example, a \$50,000 financing product with a 6-month term at an annualized interest rate of 60% will cost the merchant \$8,000 in total interest expenses. That same \$50,000 financing product over a 24-month term would cost the merchant \$21,000 in total interest expenses, despite having a much lower 36% annualized interest rate. Overall, the merchant would pay \$13,000 more in interest expenses for the longer-term product, but that may not be in the best interest of the business. In the case of a purchase of inventory, the lower rate, longer-term financing product would be more expensive to the small business despite the lower annualized rate. This example illustrates how annualized rates can cause confusion and distort the true cost of a financing product.

That is why some small business owners prefer alternative financing products like merchant cash advances as opposed to a loan with fixed payments and pricing. A merchant cash advance is the purchase of a small business’ future credit card receivables and doesn’t have a defined term. The payback amount is determined daily by the percentage of receipts the merchant collects. This product allows the merchant to ignore terms or rates and allows them to make a financing decision based on the amount of revenue they believe the investment will allow them

to collect. Referring back to the example of a purchase of inventory, the merchant will pay back the advance at roughly the rate they are able to sell the inventory, thus saving them the interest expense of a long-term, fixed rate loan.

***California has an opportunity to lead on a new and relevant solution.***

The State of California and DBO have an opportunity to create a national standard that provides small businesses with a disclosure that is specifically designed for commercial finance. True leadership will mean doing more than another square-peg-round-hole attempt to attach consumer laws designed in the 1960s to a growing and innovative industry. We are encouraged by the approach Senator Glazer took with SB 1235 because he understood that any disclosure should be clear, efficient and provide the merchant with meaningful information. We believe some industry efforts to provide disclosure to small business owners is intentionally complex and confusing to merchants. DBO is in a position to implement SB 1235 in a way that will provide clarity and transparency to California business owners. The next steps DBO takes can offer more than a simpler product—they can give small business owners the security of knowing every company offering financial products in the state is following the same rules.

We would also encourage DBO to seek the opinion of small business owners. While it is important to hear from companies offering financing products in California (both licensed and non-licensed), trade associations, consumer groups, and other stakeholders, by far the most important voice belongs to actual small businesses. Much like CFPB, Federal Reserve and other regulators, we feel it is important for DBO to reach out and poll various proposed disclosures with California small businesses to receive their input.

We look forward to working with DBO to implement SB 1235 and continuing to help serve California's small business community.

Respectfully,

Stephen Denis  
Executive Director  
Small Business Finance Association