



Department of Business Oversight, Legal Division
 Attn: Mark Dyer, Regulations Coordinator
 1515 K Street, Suite 200
 Sacramento, California 95814-4052
 Via email: regulations@dbo.ca.gov

January 22, 2019

Re: Small Business Disclosures, FILE NO: PRO 01-18

Dear Mr. Dyer,

On August 31st, the California State Legislature passed the most significant financial protection bill in the nation for small business owners. SB 1235 is the first law in the country to respond to the growing

Contact: info@borrowersbillofrights.org

need for small business finance truth in lending standards, following calls for action by the leaders of the Federal Reserve, the US Treasury Department, the nonprofit sector, and the industry itself.ⁱ

We, the undersigned, are a broad industry & nonprofit coalition, including nearly all the organizations who supported SB 1235. We collectively represent hundreds of California small business lenders, fintech companies, advocacy and community organizations, small business service providers and CDFIs, as well as tens of thousands of small businesses. **We strongly urge the Department of Business Oversight to adopt the recommendations in the following letter submitted by the Responsible Business Lending Coalition (RBLC).**

Small business financing has changed. Many small businesses now commonly borrow at APRs previously unheard-of in small business lending. A study by Opportunity Fund found some California small businesses paying APRs averaging 94%, and as high as 350%, without these rates being disclosed to the borrower.ⁱⁱ More troubling is that the average payment was approximately double what the small business could afford.

According to the US Small Business Administration (SBA), small businesses are responsible for two-thirds of all private sector jobs that have been created since the Great Recession.ⁱⁱⁱ Access to capital, aided by technology, has been an essential part of this growth. **However, small business owners must have the opportunity to understand the financing they are being offered in a clear, concise manner that enables informed comparison across all their financing options.** Disclosure of APR and estimated monthly payments are some of the elements necessary for informed comparison.

Thank you for the opportunity to comment. We look forward to working with the Department of Business Oversight on the development of these disclosures, for the good of California's small businesses.

Sincerely,

Accion
ANewAmerica
Arcata Economic Development Corporation (AEDC)
Asian Business Association
Asian Pacific Islander Small Business Program (APISBP)
Bankers Small Business CDC of California
Business for Good San Diego
Business Center for New Americans
California Asian Chamber of Commerce
California Association for Micro Enterprise Development (CAMEO)
California Capital Financial Development Corporation
California Hispanic Chambers of Commerce (CAHCC)

Contact: info@borrowersbillofrights.org

California Metals Coalition
California Resources and Training (CARAT)
CDC Small Business Finance
Colorado Lending Source
Community Housing Opportunities Corporation (CHOC)
Crane Works
Economic Development & Financing Corp. (EDFC)
El Parajo
Faith and Community Empowerment (FACE)
Flasher Barricade Association
Funding Circle
The Greenlining Institute
Halo Business Finance
Hispanic Chambers of Commerce of San Francisco (HCCSF)
Human Scale Business
Invest in Women Initiative
Jefferson Economic Development Institute (JEDI)
Justine PETERSEN
Leadership for Urban Renewal Network (LURN)
Lending Club
Lighter Capital
Main Street Launch
The Marketplace Lending Association (MLA. Members include Lending Club, Prosper, Funding Circle, Avant, Marlette Funding, Affirm, Common Bond, Upstart, Peer Street, Lending Point, College Ave, and SoFi)
Mission Driven Finance
Mission Economic Development Agency (MEDA)
Mountain Biz Works
Montecito Bank & Trust
Multifunding
Nav
National Federation of Filipino American Associations (NaFFAA)
Northern California Small Business Development Corporation (Nor-Cal FDC)
Northern California Community Loan Fund
Oakland African American Chamber of Commerce
Opportunity Fund
Pacific Community Ventures (PCV)
Public Law Center

The Responsible Business Lending Coalition (RBLC Members include Accion, Community Investment Management, Funding Circle, Lending Club, Opportunity Fund, Small Business Majority, and the Aspen Institute)

Sac Black Biz

Sierra Business Council

Silver Lining

Small Business California

Small Business Finance Fund (SBFF)

Small Business Finance Institute (SBFI)

Small Business Majority (SBM)

StreetShares

Venturize

Vermont Slauson Economic Development Corporation (VSEDC)

Women's Economic Ventures (WEV)

The Woodstock Institute

Working Solutions

3 Core

ⁱ US Treasury Department: "Small Business Borrowers Will Likely Require Enhanced Safeguards"

<https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx>;

Federal Reserve Governor Brainard noted that "Some have raised concerns about the high APRs associated with some online alternative lending products. Others have raised concerns about the risk that some small business borrowers may have difficulty fully understanding the terms of the various loan products or the risk of becoming trapped in layered debt that poses risks to the survival of their businesses."

<https://www.federalreserve.gov/newsevents/speech/brainard20150930a.pdf>

Federal Reserve Bank of New York President Dudley: "There are individuals who try to take advantage of owners of new businesses by providing them with poor advice or overcharging them for credit... it would be helpful to have consistent standards and transparency requirements for organizations that lend to small businesses. Such standards and requirements exist for lending to households, and I believe the same justification exists to extend these requirements to small businesses."

<https://www.newyorkfed.org/newsevents/speeches/2015/dud150508.html>

OCC: "Should the OCC use its chartering authority as an opportunity to address the gaps in protections afforded individuals versus small business borrowers, and if so, how?" <https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf>

ⁱⁱ Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending," 2016.

<https://www.opportunityfund.org/media/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/>.

Woodstock Institute, "Analysis of Business Loan Terms" also identifies undisclosed effective interest rates ranging up to 350%.

http://www.woodstockinst.org/wp-content/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf

ⁱⁱⁱ US Small Business Administration, "Small Business Job Creation Deconstructed," 2017

https://www.sba.gov/sites/default/files/Job_Creation_fact_sheet_FINAL_0.pdf



January 22, 2019

Department of Business Oversight, Legal Division
Attn: Mark Dyer, Regulations Coordinator
1515 K Street, Suite 200
Sacramento, California 95814-4052
Via email: regulations@dbo.ca.gov

Re: Small Business Disclosures, FILE NO: PRO 01-18

Dear Mr. Dyer,

Small business financing has changed. Small businesses now commonly pay effective APRs of higher than 50%—sometimes as high as 350%—without these rates ever being disclosed to them.¹ As you know, the federal Truth in Lending Act protects consumers but does not protect small businesses. In the following letter, we hope to provide helpful, common-sense feedback to assist the Department of Business Oversight (“the Department”) in implementing Senate Bill 1235 for the benefit of California’s small businesses and economy.

Research at the Federal Reserve has documented that today, small businesses are often not able to make informed comparisons between the prices of different credit options they may be considering.² Inhibited in making informed choices, they may overpay for credit, impacting their ability to grow and hire and leading some to struggle and close.

¹ Opportunity Fund, “Unaffordable and Unsustainable: The New Business Lending,” 2016.

<https://www.opportunityfund.org/media/blog/unaffordable-and-unsustainable-new-opportunity-fund-report/>.

Woodstock Institute, “Analysis of Business Loan Terms,” also identifies undisclosed effective interest rates ranging up to 350%.

http://www.woodstockinst.org/wp-content/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf.

² In 2015, Federal Reserve researchers presented small business owners with a series of typical online business loan disclosures used in the market. They asked the small business owners if anything seemed confusing, or if any additional information was needed. Typical replies included “No, it’s pretty straightforward,” and “I can’t think of anything more I would like to see, really.” However, when asked what rate they would pay, the small business owners did not know, and often appeared not to realize that they did not know. Answers included 28%, 5%, 9.8%, and topped out a “a whopping 30%.” The actual rate was 60%. None realized it was that high. Federal Reserve Bank of Cleveland, “Alternative Lending through the Eyes of ‘Mom-and-Pop’ Small-Business Owners,” 2015.

<https://www.clevelandfed.org/en/newsroom-and-events/publications/special-reports/sr-20150825-alternative-lending-through-the-eyes-of-mom-and-pop-small-business-owners.aspx>.

Transparent price disclosure is a basic component of free and efficient markets. Without it, market competition on price does not occur effectively. Instead of virtuous competition driving prices down, we fear that a lack of transparent disclosure is instead permitting some providers to overcharge small businesses above a competitive market rate. In a sense, these providers are collecting economic rent on their customers' lack of information.

Federal Reserve Bank of Philadelphia President Harker spoke vividly last year of the need for small business transparency standards: "I hear these stories constantly of small businesses in particular getting into a situation where they didn't quite know what they signed up for, and then they walk into their community bank and say, 'I've got to get out of this deal, it's killing me. I signed up online for this thing, and I thought it sounded good. But I really didn't understand it, I guess, and now I'm really in trouble.' And so, there are good actors and bad actors... That is the role of the regulators, and not just at the national level..."³

The California Department of Business Oversight is answering this call. The California Legislature gave a strong mandate to the Department through its bipartisan votes of 72-3 in the Assembly and 28-6 in the Senate for SB 1235. We are confident in the Department's ability to implement SB 1235 to protect California small businesses and create a level playing field for small business financing to grow in a responsible manner.

Our recommendations draw particularly on the *Small Business Borrowers' Bill of Rights*, which served as Senator Glazer's inspiration for SB 1235. In 2015, the Responsible Business Lending Coalition ("RBLC") brought together leading fintech innovators, small business advocates, and nonprofit organizations around a common goal. To encourage responsible innovation, and discourage irresponsible financing practices, the RBLC launched the *Small Business Borrowers' Bill of Rights*.⁴ This document became the first cross-sector consensus on responsible small business lending standards. Among the six topics the *Small Business Borrowers' Bill of Rights* addresses, the first calls for transparent disclosure of price and terms very similar to what is now legally required by SB 1235.

The *Small Business Borrowers' Bill of Rights* has been signed by over 90 lenders, fintech companies, nonprofit organizations, small business groups, advocates, think tanks, and more. All

³ Federal Reserve Bank of Philadelphia President Harker, 2017. <https://youtu.be/6q6RWVsAaCY?t=1h34m45s>

⁴ The mission of the Responsible Business Lending Coalition (RBLC) is to drive responsible practice in the small business lending sector. The RBLC's members are Accion and Opportunity Fund, the two largest nonprofit CDFI small business lenders; Funding Circle and Lending Club, two leading FinTech innovators in marketplace lending; Community Investment Management, an impact-driven investor in small business financing; the Aspen Institute, a nonpartisan policy studies organization and the facilitator of the coalition; and Small Business Majority, a nonprofit trade association and advocate for small businesses.

signatory lenders have agreed to abide by the detailed practice standards it sets out, including disclosure of annual percentage rate (“APR”) or Estimated APR.

We root the following recommendations in two central goals of a disclosure system: a) comparability and b) informed consent. These also serve as the purposes of the federal Truth in Lending Act (“TILA”), which requires creditors to disclose key information about consumer credit transactions “so that the consumer will be able to compare more readily the various credit terms available” and “avoid the uninformed use of credit.”⁵ To be successful, the regulations implementing SB 1235 must enable price comparison between loans, lines of credit, merchant cash advances (“MCAs”), factoring, and lease financing.

⁵ 15 U.S.C. §1601. <https://www.govinfo.gov/content/pkg/USCODE-2009-title15/html/USCODE-2009-title15-chap41.htm>.

Summary of Key Recommendations for SB 1235 Small Business Financing Disclosures

- 1) APR or Estimated APR should be disclosed for all small business financing products.
 - APR is the only established metric that enables informed comparisons of the cost of capital over time, and between products of different dollar amounts and term lengths. This is why APR is the long-standing, familiar price metric, vetted over 50 years of the Truth in Lending Act. APR can, and must, be disclosed for all financing products. (See page 11)
- 2) For sales-based transactions such as merchant cash advances, Estimated APR should be calculated with sales estimates produced by the proposed Historical Method or through the proposed Opt-in Program.
 - The Historical Method of estimating future sales is prescriptive to provide consistency and prevent “gaming” by providers. Sales projections would be fixed at the average sales volume over a certain number of months preceding the application. (See page 33)
 - The Opt-In Program would allow providers flexibility to estimate sales projections via the method they use in underwriting the financing when calculating Estimated APR. The provider would apply to the DBO and agree to report to the DBO the disclosed Estimated APRs vs. the actual Retrospective APRs to ensure sufficient accuracy. (See page 37)
- 3) For open-end transactions, Estimated APR should not include a loophole when considering fees.
 - The Department should utilize the calculation for term loans, by applying two assumptions: Credit lines are drawn in full at origination, and minimum payments are made. (See page 42)
- 4) Total Payments Per Month or Projected Payments Per Month should be disclosed in dollars.
 - This enables direct comparison of payments charged by products offered with daily, weekly, or monthly payments, and between products with fixed or sales-based payments. (See page 62)
- 5) APR calculations should bring transparency to the abusive practice of “double dipping.” (See page 54)
- 6) Prepayment language should prevent hidden prepayment penalties.
 - Providers should disclose the minimum total cost of capital in the event of early repayment, and whether any non-interest finance charges are due in the event of early repayment. (See page 52)
- 7) Timing and formatting of disclosures should maximize comparability between products. (See page 67)
 - Disclosure elements should appear any time specific terms are summarized for the borrower, including in prequalified offers and offers presented by a broker.
 - Disclosure elements should be visually distinct from other content on an offer summary, and appear before and larger than other content.
 - They should appear in the following order: Amount of Funds Provided, APR, payment information including Total Payments per Month or Projected Payments Per Month information, Term or Estimated Term, Financing Charge, Prepayment.
 - Some explanatory language should be mandated, describing APR and other terms. (See page 64)
- 8) The Department should offer online APR calculation formulas or calculators. (See page 69)
- 9) The Department should offer a public complaint portal to support enforcement. (See page 73)

Table of Contents

I.	Illustrative Sample Disclosures.....	6-8
II.	Definitions.....	9-10
III.	Annualized Rate Disclosure.....	11-24
	A. APR should be adopted.....	11-16
	B. ACC should not be adopted.....	17-20
	C. Dollar cost is not sufficient.....	21-22
	D. Other types of rates.....	23-24
IV.	Types of Commercial Financing.....	25
V.	Closed-End Transactions: Calculating APR.....	26
VI.	Sales-Based Transactions: Calculating Estimated Term and Estimated APR.....	27-41
	A. Historical Method - Based on historical sales.....	33-36
	B. Opt-In Program - Provider’s internal assumptions, with reporting.....	37-41
	Open-End Credit Plans: Calculating Estimated APR.....	42-44
VII.	Factoring & Asset-Based Lending Transactions with Master Financing Agreements	45-48
VIII.	APR Calculation and Standardized Time Periods.....	49-50
IX.	Reliance Upon Internal Underwriting Criteria to Calculate Estimated Term and APR....	51
X.	Prepayment Policies.....	52-53
XI.	“Double Dipping” and the Calculation of APR and Amount of Funds Provided.....	54-57
XII.	Tolerances.....	58
XIII.	Fees and Charges Included in an Annualized Rate Calculation.....	59-61
XIV.	Disclosure of Method, Frequency, and Amount of Payments.....	62-63
XV.	Explanatory and Qualifying Language in Connection with Estimated Term and Estimated Annualized Rates.....	64-66
XVI.	Disclosure Formatting.....	67-68
XVII.	Suggestion for Calculation Aids	69-72
XVIII.	Complaint Reporting.....	73

Appendices

- A. Preliminary draft rules language for calculation of APR
- B. National Consumer Law Center letter regarding APR and ACC, June 30, 2018
- C. Conference of State Bank Supervisors Fintech Industry Advisory Panel recommendations for small business disclosure standards including APR, excerpt
- D. Examples of small business financing companies already disclosing APRs

I, Illustrative Sample Disclosures

To clearly illustrate our coalition recommendations, we begin our comment with examples of disclosures that meet the requirements we propose. These are not mandated forms, but examples of compliant disclosure approaches a provider could adopt. They are designed to allow a customer to compare their financing options in a way that is not possible today, including using APR or Estimated APR, the monthly impact on their cash flow, and prepayment considerations.

Figure 1 - Example disclosure of a closed-end term loan		
Amount of Funds Provided:	\$19,400	This is your loan amount of <u>\$20,000</u> minus <u>\$600</u> in fees or charges that will be withheld.
APR:	18.17%	This represents your total cost, expressed as an annualized rate you can compare with the APRs of other options.
Monthly Payment:	\$703.04	
Term	36 months	
Finance Charge	\$5,309.51 in interest + <u>\$600 origination fee</u> = \$5,909.51	
Prepayment	<p><input type="checkbox"/>Yes / <input checked="" type="checkbox"/>No - If you pay off the financing before the Term, will you be required to pay finance charges other than interest since your last payment?</p> <p><input type="checkbox"/>Yes / <input checked="" type="checkbox"/>No - Does paying off ahead of the Term result in any additional fees or charges, not already included in the Finance Charge?</p>	

Figure 2 - Example disclosure of an open-end line of credit		
Amount of Funds Provided:	\$19,200	This is your loan amount of <u>\$20,000</u> minus <u>\$800</u> in fees or charges that will be withheld.
APR:	21.40%	This represents your total cost, expressed as an annualized rate you can compare with the APRs of other options.
Projected Payments Per Month:	\$958.58	Your minimum payment is 4% of your outstanding draw amount, plus interest and fees. If you draw down your entire line and make only the minimum payments, your monthly payment will average \$958.58 including fees.
Term	36 months	Your line of credit will be open for 36 months. If you draw down the entire line and make only minimum payments, you will pay down your balance in 25 months.
Estimated Finance Charge	\$3,464.51 in interest \$500 in account management fees (\$20 per month) \$200 draw fee (1% of draw amount) <u>+ \$600 origination fee</u> = \$5,909.51	
Prepayment	<p><input type="checkbox"/> Yes / <input type="checkbox"/> No - If you pay off the financing before the Term, will you be required to pay finance charges other than interest since your last payment?</p> <p><input type="checkbox"/> Yes / <input type="checkbox"/> No - Does paying off ahead of the Term result in any additional fees or charges, not already included in the Finance Charge?</p>	

Figure 3 - Example disclosure of a variable-term merchant cash advance or loan		
Amount of Funds Provided:	\$19,400	This is your financing amount of <u>\$20,000</u> minus <u>\$600</u> in fees or charges that will be withheld.
Estimated APR:	131%	This represents your total cost, expressed as an estimated annualized rate you can compare with other options.
Daily Payment Amount:	10% of sales through XYZ credit card processor	
Projected Payments Per Month	\$5,000	We estimate your daily payments will total about \$5,000 per month, based on sales projections of \$50,000 per month.
Estimated Term	5 months	Estimate based on sales projections of \$50,000 per month.
Finance Charge	\$5,309.51 flat fee + <u>\$600 origination fee</u> = \$5,909.51	
Prepayment	<p>[Yes] / [No]- If you pay off the financing before the (Estimated) Term, will you be required to pay finance charges other than interest since your last payment? The finance charge due at payoff could be as high as [<u>\$5,309.51</u>].</p> <p>[Yes] / [No] - Does paying off ahead of the (Estimated) term result in any additional fees or charges, not already included in the Finance Charge?.</p>	

II. Definitions

As requested by the Department, following is a list of terms that may require definition in a regulation implementing SB 1235.

- Financing Amount
 - This is the contractual amount of the financing, before any fees are deducted. In other words, it is the “Amount of Funds Provided” plus any fees or charges withheld before disbursement.
- Total Repayment Amount
 - This is the amount the borrower agrees to pay the lender. It is the sum of all scheduled or projected payments. In the cases of sales-based transactions, it is generally specified in the contract.
- Projected Sales Volume
 - Projected Sales Volume is the sales volume for sales-based transaction projects. For the Historical Method, it is based on the customer’s historical sales volume over a defined number of months preceding the application.
- Retrospective Annual Percentage Rate (“RAPR”)
 - This is the exact APR, calculated after financing has been fully repaid and the exact dates and amounts of payments and fees are known. It is calculated using the formula:
$$0 = \sum_{j=1}^N \frac{P_j}{(1 + rate)^{\frac{(d_j - d_0)}{365}}}$$
. This can be easily computed in common computer programs such as Microsoft Excel and Google Sheets, using the formula IRR.
- Amount of Funds Provided
 - We recommend that Amount of Funds Provided include not only the amount disbursed to the borrower, but to any third party paid on behalf of the borrower as well. This might include equipment vendors, other lenders being refinanced, etc. It would not include payments to any entity related to the provider offering the financing, unless for goods or services other than financing.
- Finance Charge
 - In defining Total Cost of Capital, it may be useful for the Department to consider referring to the Regulation Z definition and rules around the “Finance Charge,” which is the same concept as the Total Cost of Capital.
 - It should be noted that within consumer lending regulation, the term Total Cost of Credit, which sounds very much like Total Cost of Capital, is already in use and also referred to as “TCC,” though with a very different meaning. “TCC” is used

by the CFPB to describe a form of fee-inclusive interest rate.⁶ For this reason, the Department should consider using the term “Finance Charge” instead of “Total Cost of Capital.”

- In defining what charges fall within the Finance Charge, Regulation Z provides a chart, linked in the footnote below.⁷
- Split Rate
 - This is the percent of sales, overall or through particular payment processing systems, that will be taken as payment for some financing options. For example, an MCA’s daily payment may be 10% of daily sales through the small business’ payment processing system. In this example, the split rate is 10%.

⁶ The CFPB’s 2017 “Consumer Credit Card Market” uses Total Cost of Credit, and explains: “To capture the all-in cost of using credit cards, we continue to rely on our total cost of credit metric, or “TCC.” TCC captures the totality of payments by consumers to issuers as an annualized percent of cycle-ending balances. For the purposes of reporting this and other metrics in this section, we show annualized figures. In this section, for example, we show the total cost consumers incurred over the course of 2016 relative to the average aggregate outstanding balances on those accounts over the same period.” https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2017.pdf.

⁷ CFPB, “CFPB Consumer Laws and Regulations,” 2013 (page 12). https://files.consumerfinance.gov/f/201306_cfpb_laws-and-regulations_tila-combined-june-2013.pdf.

III. Annualized Rate Disclosure

Disclosure of an annualized rate is the most important element of SB 1235, and it is critical that this annualized rate be defined as APR and Estimated APR. APR is the only established metric that enables informed comparisons of the cost of capital over time, and between products of different dollar amounts and term lengths. This is why APR is the long-standing price metric that people are familiar with, vetted over 50 years of TILA. Disclosure of APR and Estimated APR is appropriate, feasible, and necessary for all commercial financing products a small business may consider.

A. APR is the only metric that enables comparability between options – The calculation of APR has been defined in federal law in order to reflect the time value of money, enabling effective comparison of cost between products of different terms.

Moreover, APR is already the required standard for lending products that small business owners often use, including credit cards, vehicle loans, personal loans, and home equity lines of credit. A metric that is not comparable with the APRs of these products would hinder small business owners in making informed cost comparisons.

APR is the time-tested rate that people know and expect – APR is the legally required standard, vetted over many years, for credit cards, mortgages, auto loans, and personal loans, including loans that are shorter than one year, such as payday loans. In the 50 years since TILA required the disclosure of APR, many issues have been considered and addressed.⁸

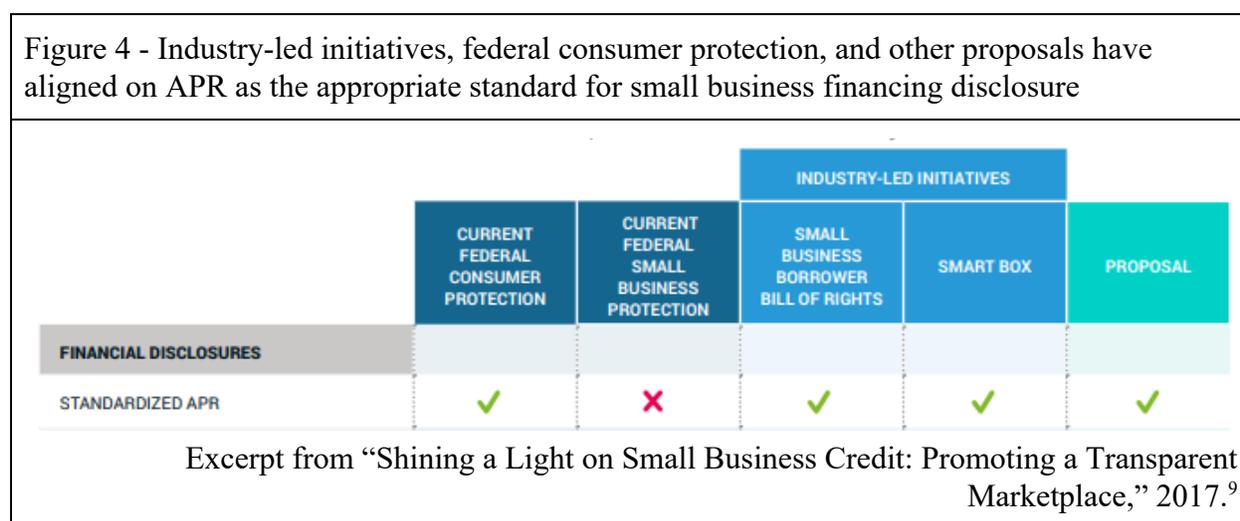
APR is already disclosed by many commercial financing providers – Industry and nonprofit organizations that have sought to address the price transparency problems in the small business financing market today have coalesced around APR and Estimated APR as the solution.

For example, when the Conference of State Bank Supervisors gathered leading online lending companies in its Fintech Industry Advisory Panel, this industry body recommended that all states adopt small business disclosure standards based on APR. Industry participants of the task force expressed concern that irresponsible disclosure practices of a small number of commercial financiers are making the entire online lending industry look irresponsible. Moreover, they expressed concern that different states may propose different metrics, and so urged the

⁸As one illustration of the widespread public expectation of APR, including for commercial financing, consider the 2015 headline published by financial advice publication NerdWallet: “Going for a Small-Business Loan? Focus on the APR.” The article advises that, “Before signing on the dotted line, it’s smart to know the clearest, most straightforward annual cost of debt — that’s the APR.” Nerdwallet, “Going for a Small-Business Loan? Focus on the APR,” 2015. <https://www.nerdwallet.com/blog/small-business/apr-small-business-loans/>.

Conference of State Bank Supervisors to encourage a standard disclosure regime across all states, based on APR.

Many commercial financing providers are self-regulating by voluntarily disclosing APR already. For example, over 90 organizations have signed the *Small Business Borrowers’ Bill of Rights*. All of these organizations that are in the business of providing commercial credit have attested that they disclose APRs. Additionally, the Innovative Lending Platform Association created a disclosure form called the “SMART Box” which includes disclosure of APR. Other industry participants who are not involved in either effort also disclose APRs, including some SBA lenders.



Establishing APR would simply codify the existing best practices of the small business financing industry.

APR can be calculated for all necessary types of financing – While it has been argued that APR cannot be calculated for variable-term products such as merchant cash advances, some providers of these products already do calculate and disclose it, and are among the signatories of the *Small Business Borrowers’ Bill of Rights* and adopters of the SMART Box.

Other providers calculate APR but do not disclose it to borrowers. In the securitization documents excerpted in Figure 5 below, one provider advertises to investors a 48% annual return on the merchant cash advances and loans in the security. This annual return is equivalent to an APR. If this information is disclosed to investors, surely the small business borrowers can be provided similar transparency.

⁹Progressive Policy Institute, “Shining a Light on Small Business Credit: Promoting a Transparent Marketplace,” 2017. https://www.progressivepolicy.org/wp-content/uploads/2017/11/PPI_SmallBizCredit_2017.pdf.

Figure 5 - Excerpt from an MCA securitization, including an annual return of 48%

- The credit quality of the collateral, the performance of [REDACTED]'s small business loan and MCA portfolio, and proposed pool.
 - The pool comprises short-term loans and MCAs with a weighted-average remaining term or estimated underwritten turn of approximately [9.55] months.
 - The pool has an expected weighted-average annual return on the collateral pool of approximately 48%, which provides a significant level of first loss protection in the form of excess spread.

Additionally, quite a few simple online calculators have been developed to help small business owners trying to determine the APRs of the small business financing products they are considering, including financing without a fixed term such as merchant cash advances.¹⁰ Below is one such calculator, developed by small business credit company Nav. It illustrates the potential simplicity of calculating APR for these products, with four clear input fields.

¹⁰ Examples of online APR calculator for sales-based transactions include:

Fundera, "Merchant Cash Advance Calculator: How Much Can You Afford?" 2018.

<https://www.fundera.com/business-loans/business-loan-calculators/merchant-cash-advance-calculator>.

Nerd Wallet, "Is a Merchant Cash Advance Right for Your Business?" 2018.

<https://www.nerdwallet.com/blog/small-business/merchant-cash-advance-small-business/>.

Lendio, "MCA (Merchant Cash Advance) Financing Payments Calculator," n.d.

<https://www.lendio.com/calculators/embed-mca?affiliate=4247260739>.

American Merchant Brokers, "APR Calculator," n.d.

<https://www.americanmerchantbrokers.com/merchant-cash-advance-calculator.html>.

Merchant Maverick, "Merchant Cash Advance Calculator," n.d.

<https://www.merchantmaverick.com/merchant-cash-advance-calculator/>.

Figure 6 - Nav's Merchant Cash Advance APR Calculator¹¹

MERCHANT CASH ADVANCE
APR Calculator

Advanced Amount \$ 20,000

Payback Amount \$ 24,000

% of Future Card Sales 15 %

Projected Monthly Card Sales \$ 20,000

CALCULATE

Daily Payment **\$100.00**

Daily Interest Rate **0.1563%**

APR **57.06%**

Repaid in about **240 days**

Total Financing Cost **\$4,000.00**

Powered by nav

APR has broad, expert support – For all of these reasons, APR is the annualized rate metric discussed by regulators and other experts. Following are a few examples:

- *Federal Reserve Research, 2018*: When Federal Reserve researchers studied the need for disclosures they use APR to describe costs, including for merchant cash advances. “Depending on the speed of repayment, equivalent annual percentage rates (APRs) can exceed 80% or even rise to triple digits,” they wrote.

¹¹Nav, “Merchant Cash Advance APR Calculator,” n.d.
<https://www.nav.com/business-loan-calculators/merchant-cash-advance-apr-calculator/>.

This research also noted the expectations of small business owners themselves to APR, and their aversion to less familiar forms of rate. “...Several [business owners] perceived that lenders were attempting to ‘hide’ or ‘conceal’ true costs by excluding basic information about their products from their sites or by using terminology with which they were less familiar (for example, ‘simple interest’ or ‘factor rate’ versus APR).”

The research also addressed the concern that it is not possible to calculate a precise APR or payment amount for products with a variable term. When small business owners were asked about estimation in key disclosures, “Nearly all said this level of detail, even if estimated or presented as a range, should be available to potential borrowers before they apply and turn their businesses’ financial data over to the lenders.”¹²

- *Federal Reserve Governor Lael Brainard*: In a speech about online business lending, Governor Brainard highlighted that, “some have raised concerns about the high APRs associated with some online alternative lending products. Others have raised concerns about the risk that some small business borrowers may have difficulty fully understanding the terms of the various loan products or the risk of becoming trapped in layered debt that poses risks to the survival of their businesses.”¹³
- *New York Department of Financial Services*: In its Online Lending Report 2018, the New York Department of Financial Services writes: “There also is not a uniform practice among respondents to disclose in a clear, simple and transparent manner the full price of a loan, including all fees, charges and other costs to their borrower either as included in the applicable annual percentage rate of the loan or in addition to the APR.”¹⁴
- *The Bipartisan Policy Center*: The Center’s 2018 Main Street Finance white paper calls for small business disclosure standards including APR. “There can also be confusion around some forms of small business credit, called merchant cash advances. These products are not classified as loans and, as such, are not expressed in terms of an APR, making it challenging to compare with other types of credit products.”¹⁵

¹² Board of Governors of the Federal Reserve System, “Press Release: Federal Reserve Releases Findings from Study of Small Business Owners’ Perspectives on Online Lenders and Products,” 2018.

<https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf>.

¹³ Board of Governors of the Federal Reserve System, “Remarks by Lael Brainard: Community Banks, Small Business Credit, and Online Lending,” 2015. <https://www.federalreserve.gov/newsevents/speech/brainard20150930a.pdf>.

¹⁴ Bipartisan Policy Center, “Main Street Matters Ideas for Improving Small Business Financing,” 2018.

<https://bipartisanpolicy.org/wp-content/uploads/2018/07/Main-Street-Matters-Ideas-for-Improving-Small-Business-Financing.pdf>

¹⁵ New York State Department of Financial Services, “Online Lending Report,” 2018.

https://www.dfs.ny.gov/reportpub/online_lending_survey_rpt_07112018.pdf.

- *Former Treasury Official Jessica Milano*: Milano published a policy paper on the need for small business disclosure standards, called Shining a Light. This proposal centrally includes APR.¹⁶
- *Former SBA Administrator Karen Mills*: In her Harvard Business School whitepaper “The State of Small Business Lending,” this former head of the SBA calls for disclosure standards. “The best model disclosures will incorporate APRs, as well as a host of other metrics.”¹⁷
- *California Department of Business Oversight*: Not least, when the Department itself sought to understand the prices charged in the online small business lending market, it requested disclosure in terms of APR. The 2015 survey published median APRs ranging from 15.5% to 51.8%.¹⁸

For all of these reasons, we strongly urge the Department to adopt APR as the annualized rate required under SB 1235.

¹⁶Progressive Policy Institute, “Shining a Light on Small Business Credit: Promoting a Transparent Marketplace,” 2017. https://www.progressivepolicy.org/wp-content/uploads/2017/11/PPI_SmallBizCredit_2017.pdf.

¹⁷ Harvard Business School, “The State of Small Business Lending: Innovation and Technology and the Implications for Regulation,” 2016. http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf.

¹⁸ California Department of Business Oversight, “SURVEY OF ONLINE CONSUMER AND SMALL BUSINESS FINANCING COMPANIES – 01/01/2010 through 06/30/2015.” http://www.dbo.ca.gov/Press/press_releases/2016/Survey%20Response%20Summary%20Report%2004-08-16.pdf.

B. Annual Cost of Capital Would Be Misleading and Should Not Be Adopted

The Annual Cost of Capital (“ACC”) metric should not under any circumstances be adopted. ACC is a newly invented metric, proposed by industry, that looks and feels like a traditional APR but calculates to be a much lower number than the actual APR or interest rate. This would lead small businesses to make inaccurate cost comparisons. It would misguide them towards more expensive non-bank financing.

In addition to its drawbacks, ACC offers no compelling advantage over APR. If a provider can calculate an ACC, it can calculate an Estimated APR. Both require the same estimation of sales projections and thus term length. There is no compelling reason to pursue ACC.

To summarize the shortcomings of ACC, we refer below to a letter provided by Carolyn Carter, the National Consumer Law Center’s Deputy Director, a national expert on disclosure regulation and co-author of the National Consumer Law Center’s definitive legal publication on the Truth in Lending Act.

Figure 7 - Excerpt from National Consumer Law Center letter warning about ACC. The complete letter is included in Appendix B.

You have asked for my opinion about the use of a newly-designed metric, the “Annualized Cost of Capital” or “ACC,” to disclose the cost of extensions of credit to small businesses. I have researched and written on consumer lending issues for over thirty years, and am one of the authors of the National Consumer Law Center’s (NCLC) *Consumer Credit Regulation* treatise (2d ed. 2015) and a contributing author to its *Truth in Lending* treatise (9th ed. 2015).

My opinion is that this metric would be not only uninformative but affirmatively misleading. It would sow confusion and make accurate comparisons to other sources of credit impossible. Authorizing this misguided metric would harm both small businesses and consumers.

The APR is the keystone of the disclosure system created by the federal Truth in Lending for consumer credit. It is designed to capture the true cost of credit, taking into account both the interest rate and flat fees. It enables a borrower to make an apples-to-apples comparison of the cost of two loans *even if those loans are for different amounts, have a different mix of interest and flat fees, are repayable over different lengths of time, or have irregularities in the amounts or due dates of payments.*

The Truth in Lending APR was mandated *precisely because of the inadequacies of metrics like the ACC.* Prior to the Truth in Lending Act, states expressed the limits on interest rates through a welter of confusing and misleading measures. One common measure was the “add-on” interest rate: a measure of the cost of credit much like the ACC that did not take the declining balance into account (*i.e.*, the fact that, as the loan is paid off, interest accrues on a smaller balance).

Following are some of the reasons expanding on why the National Consumer Law Center characterizes ACC as “not only uninformative but affirmatively misleading.”

ACC fails to achieve the disclosure goal of comparability – ACC looks and feels like a traditional APR, but always calculates to be a lower number than the actual APR. Meanwhile, APR will remain the legally required standard for credit cards, home equity lines of credit, and other options small business owners consider. Similarly, APR or traditional interest rate will remain standard for business loans offered by banks, as well as by nonbank providers committed to APR as a standard of transparency.

The figure below illustrates how ACC would consistently make products disclosed in ACC appear less expensive than products disclosed in APR. Considering financing of \$10,000, with a total cost of capital of \$3,000. In a 36 month term, this product would disclose an ACC of 10%, but have an actual APR of 18%. In a 12 month term, this product would disclose an ACC of 30%, but have an actual APR of 51%. And so on.

Figure 8 - ACC looks like APR, but always computes to be a lower number than APR

Financing Amount (\$)	10,000	10,000	10,000	10,000	10,000
Term (months)	3	6	12	24	36
Total Cost of Capital (\$)	3,000	3,000	3,000	3,000	3,000
Payment amount (\$/mo)	4,333.33	2,166.67	1,083.33	541.67	361.11
ACC	122%	61%	30%	15%	10%
APR	172%	97%	51%	27%	18%

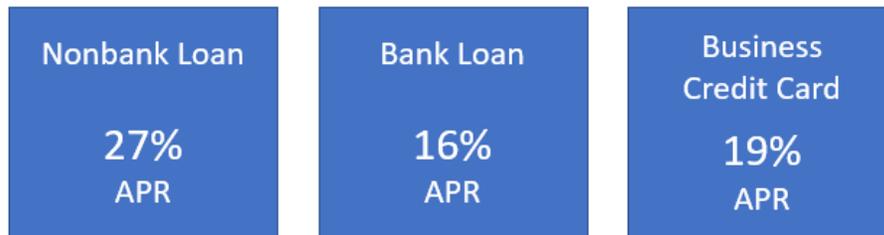
This would systematically misguide small businesses. To illustrate, consider the following choices that a small business owner might face, based on the 24 month loan from the chart above:

Figure 9: Financing options illustrating how ACC would mislead small businesses

Example: Which of these options should a small business select?



Will they realize that the nonbank loan is more expensive than the credit card, and almost twice as expensive as the bank loan? What if the business owner knew the APR for these **same options**?



While the nonbank loan disclosing a 15% ACC would appear to be less expensive than the bank loan or credit card, using the same APR metric as the other products would accurately reflect that it is significantly more expensive, 27% APR to their 16% and 19% APRs.

In a 2018 study, Federal Reserve researchers developed an interesting finding. Small business owners often did not distinguish between different percentage numbers. Most number presented as a percentage were assumed to be the “rate.” The business owners were not accustomed to distinguishing between different forms of rate, which would be necessary to compare an ACC to an APR.¹⁹

ACC fails to reflect the time value of money – In addition, unlike APR, ACC does not accurately reflect the time value of money. If a small business must repay a loan more quickly during its term, APR reflects this but ACC remains unchanged, and so fails to reflect the true cost.

¹⁹ Interview, 2018, Responsible Business Lending Coalition, Barbara Lippman, AnnMarie Wiersch, Federal Reserve Board.

This is a meaningful problem. Consider two financing options representing extreme cases, in the figure below. Both have the same \$100,000 financing amount, the same Total Cost of Capital, and the same term. They have the same ACC, but very different APRs.

In this example, Option A effectively gives the customer use of the full \$100,000 for one year. They just make one big payment at the end of the term. Option B effectively gives the customer use of only \$1 because they must repay \$99,999 on the first day. APR accurately reflects that Option A is charging the borrower 10% of the amount they get to use *over time*, while Option B is charging \$10,000 to use \$1 for a year. ACC portrays these options as identical.

Figure 10 - ACC fails to reflect the time value of money

	Financing Amount	Finance Charge	Term	Amount Repaid on Day 1	Amount Repaid on Day 365	Amount of capital the borrower pays \$10,000 to have use of over the 365 day term.	ACC	APR
Option A	\$100,000	\$ 10,000	365 days	\$ -	\$ 110,000	\$ 100,000	10%	10%
Option B	\$100,000	\$ 10,000	365 days	\$ 99,999	\$ 10,001	\$ 1	10%	1297%

Carolyn Carter of the National Consumer Law Center explains: “Because ACC fails to take the declining balance into account, it is a profoundly inaccurate measure of the cost of credit. Dissemination of this inaccurate metric would inevitably reach consumers through advertisements and the media, so would cause confusion in the consumer credit market too.”²⁰

²⁰ National Consumer Law Center, Letter on ACC, 2018. Included as Appendix B.

C. Dollar Cost is Not Sufficient

Some have suggested that annualized rates are not necessary and that Total Cost of Capital, or similar metrics of dollar cost, should be the standard offered to small businesses comparing their financing options. This is not a serious position, and would effectively misguide small businesses towards short-term, higher-cost financing.

Measures such as Total Cost of Capital do not enable borrowers to make comparisons between financing of different terms or different amounts. APRs describe the cost regardless of loan size and term.

The shortcomings of relying on dollar cost have been well described by MFTransparency, which established transparency standards in the international microfinance industry:

“When you take out a loan you are essentially ‘renting’ money. You are given money that is owned by someone else and you agree to pay them ‘rent’ (interest) for this privilege. This is just like renting anything else, an apartment for example. If you rent an apartment, a room that costs \$1,000 dollars per day is very different than a room that costs \$1,000 dollars per month. Using Total Cost of Credit is like looking at the price of an apartment, but not taking into account how long you will be able to stay!

But APR is like looking at a standardized cost per year for that same apartment:

- *\$1,000 per day = \$365,000 per year*
- *\$1,000 per month = \$12,000 per year”²¹*

Furthermore, measures of dollar cost consider only a single loan. However, the reality is that the business model of many small business financing providers is to encourage borrowers to renew their short-term financing over and over, year after year.

For example, the securitization document of the provider below shows that 78% of the MCAs included, and 57% of the loans, are to repeat borrowers.

²¹ MicroFinance Transparency, “Total Cost of Credit vs. APR,” 2010. <http://www.mftransparency.org/total-cost-of-credit-vs-apr/>.

Figure 11 - Small businesses often renew short-term financing over and over. 78% of the MCAs in this portfolio are renewals.

Collateral Description

The 2014-1 transaction pool characteristics are as of the August 31, 2014, statistical cut-off date. The receivables securitized in this transaction will be a pool of small business loans and MCAs. Summary statistics of the current portfolio data are presented below.

	Loans	MCAs	Total Portfolio
Number of Assets	4,270	2,801	7,071
Aggregate Unamortized Funded Amount	\$ 131,963,318.32	\$ 68,055,438.49	\$ 200,018,756.81
Average Unamortized Funded Amount	\$ 30,904.76	\$ 24,296.84	\$ 28,287.20
Average Funding Size	\$ 45,793.43	\$ 40,462.16	\$ 43,681.58
Weighted Average Term or Estimated Underwritten Turn	13.88	13.53	13.76
Weighted Average Remaining Term or Turn	9.65	9.35	9.55
Average Number of Contracts in Lifecycle	2.80	3.10	2.90
Average Number of Months in Lifecycle	31.16	32.90	31.75
Weighted Average Repayment Amount or Specified Amount to Funded Amount Ratio	1.33	1.31	1.32
Weighted Average CAN Capital Risk Score	8.53	9.90	9.00
Average Years in Business	12.12	12.80	12.39
Average Gross Annual Sales	\$ 1,065,096.87	\$ 769,261.40	\$ 947,909.04
Average % Gross Sales Taken	5.73%	8.11%	6.67%
Average Specified Percentage	N/A	20.39%	N/A
New Customer	43.12%	21.62%	35.81%
Renewal	56.88%	78.38%	64.19%
Weighted Average Loan Term or MCA Estimated Term			

Because of this renewal behavior, the choice a small business may be considering is not between a 6-month loan and a 3-year loan, but between using either product on an ongoing basis. APR enables small business owners to make an accurate comparison between using these products over time by making a standardized comparison of the cost over one year.

D. Other Types of Rates

Today, some providers market novel types of rates that may easily be mistaken for an interest rate, but are a lower number than the actual interest rate. This can mislead small business owners. Federal Reserve researchers studying small business financing disclosures found that small business owners often mistook numbers presented as a percentage as the interest rate.²² The Department should not permit disclosures to include metrics that could easily be mistaken for the interest rate or APR but are not actually the interest rate or APR.

Most of these novel rates are variations on the “factor rate,” which is the Financing Charge as a percentage of the loan amount. For short-term products, this is much lower number than the actual interest rate. Consider the loan below. It has a “factor rate” of 26%. To many small business owners, this may appear to be about the same cost as an expensive credit card. However, the interest rate or APR is actually 84%.

Figure 12 - Example loan comparing “Factor Rate” and APR.

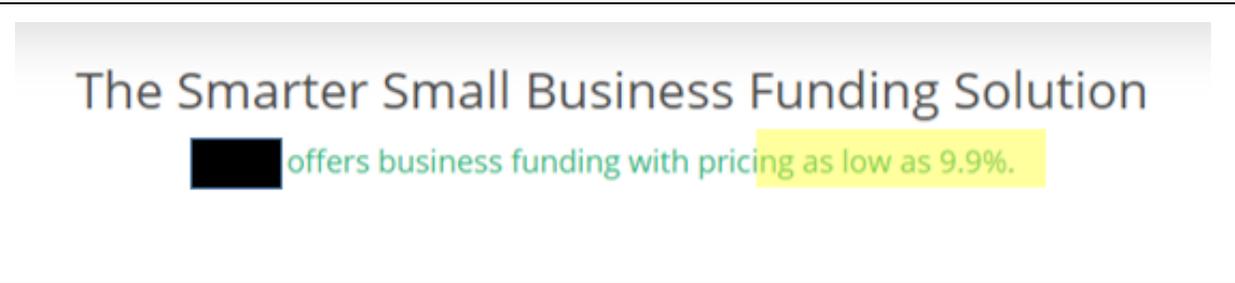
	A	B	C
1	Loan Amount	20,000	
2	Term (months)	6	
3	Payment (per month)	4200	
4	Finance Charge	5200	=B3*B2-B1
5	"Factor Rate"	26%	=B4/B1
6	APR	84%	=RATE(B2,-B3,B1)*12

Factor rate goes by many different names, including “buy rate,” “money factor,” “cents on the dollar,” and most confusingly, “simple interest rate.” The term “simple interest rate” may easily be confused to mean a traditional interest rate that does not “compound,” or charge interest on interest. For example, financial education website Motley Fool explains, “simple interest is only paid on principal, while compound interest is paid on the principal plus all of the interest that has previously been earned.”²³ However, the term “simple interest rate” as used by merchant cash advance providers is identical to “factor rate.” Sometimes providers even quote factor rate simply as “rate,” as in the example below.

²² Interview, 2018, Responsible Business Lending Coalition, Barbara Lippman, AnnMarie Wiersch, Federal Reserve Board.

²³ The Motley Fool, “What Is the Difference Between Simple Interest vs. Compound Interest?” 2018. <https://www.fool.com/knowledge-center/simple-interest-vs-compound-interest-differences-a.aspx>.

Figure 13 - Provider quoting a 9.9% factor rate as “rate.” If the term is 6 months, the equivalent interest rate or APR may be 33.2%.



The Smarter Small Business Funding Solution

■■■■ offers business funding with pricing as low as 9.9%.

This may constitute a deceptive act or practice. Moreover, permitting novel rates that are easily confused with interest rate would allow providers with high APRs to seek to bury those high APRs with a slough of lower percentage “rates.” This would dilute or eliminate the value of uniform, transparent disclosures.

IV. Types of Commercial Financing

Commercial financing products contemplated by SB 1235 will generally fall into four categories. Below is a summary of the proposed methods for calculating APR and Estimated APR for each product type, which we will then discuss in more detail.

- *Closed-end transactions*: Products with payments amounts that are defined as a dollar amount, and thus also include a fixed repayment term, are considered closed-end transactions. This includes term loans, lease financing, merchant cash advances that use payments of fixed dollar amounts, and similar products. To calculate APR, simply use the TILA method for closed-end credit.
- *Sales-based transactions*: Products with payment amounts that vary according to the small business recipient's sales volumes are considered sales-based transactions. This includes merchant cash advances and similarly structured loans repaid as a percentage of the small business's sales. Specific payment amounts are not known at origination. Estimated APR can be calculated used a Projected Sales Volume that is produced one of two proposed ways: by using the Historical Method, based on the small business' historical average sales, or by participating in the Opt In Program in which the provider uses the sales projections they have relied on in underwriting and agrees to report on the accuracy of its disclosures to the Department.
- *Commercial open-end credit plans*: This includes lines of credit or similar financing where a creditor contemplates repeated transactions. To calculate Estimated APR, use the TILA method for closed-end transactions with the assumptions that the financing is fully drawn on the origination date and minimum required payments are made.
- *Factoring*: Invoice factoring involves a provider purchasing an unpaid invoice and collecting a finance charge for the delayed payment on that invoice. To calculate Estimated APR, use a method based on the TILA method for closed-end transactions, with terms estimated using the providers' historical data about customer payment rates.

V. Closed-End Transactions: Calculating APR

APRs for term loans can be calculated as described in TILA.²⁴ TILA addresses APR calculation for financing with payment periods shorter than monthly, and for payment amounts that vary. No novel estimations are required.

There are many term loan APR calculators available online, and formulas for calculating APR in widely used programs such as Microsoft Excel and Google Sheets. For closed-end transactions of equal payments, the Microsoft Excel and Google Sheets “RATE” or “IRR” formulas are simple to use, once learned. We will discuss these specific calculations in detail in the section on “Suggestion for Calculation Aids and Formulas” sections.

For closed-end transactions with different, but anticipated payment amounts, such as financing with a period of higher payments up front, the “IRR” formula is best used. When payment amounts vary, it is not necessary or appropriate to calculate APR using one average payment amount over the course of a closed-end term. That could have the effect of producing a lower-than-accurate APR.

Lease financing, although not a loan, can use the exact same APR calculations as closed-end transactions.

Figure 14 - Equipment financing is already being described in APR

For example, NerdWallet’s small business financing comparison offers comparison of loans, lines of credit, equipment financing, and invoice factoring, all compared by APR.²⁵

Equipment financing

Financing specifically for purchasing equipment. [Learn more.](#)

Lender	APR ⓘ	Min credit score	
CURRENCY. View details	6-24% Estimated APR*	585 Min credit score	Apply Now <small>on Currency Capital's secure website</small>

²⁴ CFPB, “Appendix J to Part 1026 — Annual Percentage Rate Computations for Closed-End Credit Transactions,” n.d. <https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/J/>.

²⁵ NerdWallet, “Small Business Loans: Compare Financing,” n.d. <https://www.nerdwallet.com/small-business-loans>.

VI. Sales-Based Transactions: Calculating Estimated Term and Estimated APR

Merchant cash advances (“MCAs”) and loans with similar structures can be considered sales-based transactions.²⁶ These products have a fixed repayment amount, rather than a fixed term, and are repaid as a percentage of the small business’ sales revenue. Although some argue that calculating an Estimated APR for these products is difficult or impossible, it is feasible, practical, and necessary.

A sales-based transaction’s term and effective APR are the result of the small business customer’s sales volumes over the course of the financing. Often this includes only sales through specific payment channels, such as a specific credit card processing system, but not cash transactions.

Payments take place as a specific percentage of sales volume, and typically occur every day or every weekday, though sometimes weekly, bi-weekly, or monthly. For example, a contract may specify that 10% of daily credit card sales go towards repaying the fixed “total repayment amount” owed. If sales are \$10,000 during a specific day, the payment for that day would be \$1,000.

The financing is fully repaid, and thus the term established, when the payments made have equaled the total repayment amount defined in the contract. For example, if the total repayment amount is \$200,000 and payments of \$1,000 occur daily, the term would be 200 days.

APR, as defined by TILA, is calculated using the a) amount of capital provided, b) the amounts charged in payments and fees, and c) when those payments take place. As a result, the Estimated APR for sales-based products can be calculated based on an estimated sales projection.

Sales-Based Transaction Providers Already Have and Use These Projections

Before further discussing estimations, it is important to consider that providers of sales-based products *already do* estimate the customers’ sales projections and the resulting payments and term projections, though they may not always disclose these to the borrower. Finance companies generally do not give out money without an expectation of when it will be repaid. In fact, sales-based financing companies generally rely on the expected term they have calculated when determining the price they will charge for a specific transaction.

²⁶ Sales based transactions may include both merchant cash advances, loans, and other potentially other types of financing with a sales-based payment mechanism. As the securitization document in Figure 15 and the marketing document in Figure 18 demonstrate, these two concepts are very similar. Sales-based financing providers often sales-based products structured as both loans and advances or purchases

The estimated term considered by the provider of a variable-term product can be quite specific. In Figure 15 below, one merchant cash advance provider includes “Estimated Underwritten Turn” in its disclosures to securitization investors. The weighted average estimated term for the merchant cash advances in the securitization pool is 13.53 months. As you can see, the provider here has underwritten transactions with an “estimated underwritten term” that is specific *to two decimal places*. They anticipate the outstanding advances have a “weighted average remaining term or turn” of 9.35 months.²⁷

²⁷ The provider has also bucketed transactions into periods of 3 months, further illustrating specific term expectations. In this case, the distribution of MCA “Estimated Turn” advances is quite clustered—66.52% of the portfolio was written in anticipation of a term between 12.01 and 15 months.

Figure 15 - MCA securitization excerpt indicating estimated term

Collateral Description

The 2014-1 transaction pool characteristics are as of the August 31, 2014, statistical cut-off date. The receivables securitized in this transaction will be a pool of small business loans and MCAs. Summary statistics of the current portfolio data are presented below.

	Loans	MCAs	Total Portfolio
Number of Assets	4,270	2,801	7,071
Aggregate Unamortized Funded Amount	\$ 131,963,318.32	\$ 68,055,438.49	\$ 200,018,756.81
Average Unamortized Funded Amount	\$ 30,904.76	\$ 24,296.84	\$ 28,287.20
Average Funding Size	\$ 45,793.43	\$ 40,462.16	\$ 43,681.58
Weighted Average Term or Estimated Underwritten Turn	13.88	13.53	13.76
Weighted Average Remaining Term or Turn	9.65	9.35	9.55
Average Number of Contracts in Lifecycle	2.80	3.10	2.90
Average Number of Months in Lifecycle	31.16	32.90	31.75
Weighted Average Repayment Amount or Specified Amount to Funded Amount Ratio	1.33	1.31	1.32
Weighted Average CAN Capital Risk Score	8.53	9.90	9.00
Average Years in Business	12.12	12.80	12.39
Average Gross Annual Sales	\$ 1,065,096.87	\$ 769,261.40	\$ 947,909.04
Average % Gross Sales Taken	5.73%	8.11%	6.67%
Average Specified Percentage	N/A	20.39%	N/A
New Customer	43.12%	21.62%	35.81%
Renewal	56.88%	78.38%	64.19%
Underwritten Loan Term or MCA Estimated Turn			
Less than or equal to 3	0.00%	0.00%	0.00%
3.01 to 6	3.13%	0.60%	2.27%
6.01 to 9	12.26%	3.28%	9.21%
9.01 to 12	30.67%	15.53%	25.52%
12.01 to 15	25.14%	66.52%	39.22%
15.01 to 18	16.80%	12.74%	15.42%
18.01 or greater	12.00%	1.32%	8.36%

Interestingly, this disclosure also indicates how similar closed-end loans and MCAs can be from the perspective of the provider. Like many leading MCA companies, this provider offers both closed-end term loans and MCAs. The products are so similar that they are neatly summarized on the same table with the same fields. The weighted average term of the loan product is 13.88 months, and 13.53 months for MCAs. The average financing amount is \$45,793 for loans and \$40,462 for MCAs, and so on. This contradicts the claim that sales-based financing must be treated entirely differently than closed-end loans.

Although an MCA may have a variable term by structure, the contract may also imply a specific or maximum term length by specifying a minimum payment amount, or a term by which penalties will accrue. For example, while the contract below in Figure 16 specifies that the “Transaction Is Not a Loan” and that payment of the financing will occur as 8% of the small business customers’ sales, it also includes a “Specified Daily Amount” of \$197.00. This “Specified Daily Amount” indicates that the provider has calculated an estimate of the projected sales volume, which they have based this payment amount on. The “Specified Daily Amount” also implies a specific term. If payments of \$197.00 are made daily, the \$26,600.00 would be repaid in 135 payments.

Figure 16 - Example MCA contract with a specified payment amount

<p>1. Purchase and Sale Transaction</p> <p>1.1 Sale; Amount Sold; Purchase Price. Seller hereby sells to Purchaser all of Seller’s right, title and interest in a finite amount of Seller’s Future Receivables, as defined herein, the dollar value of which is <u>\$ 26,600.00</u> (the “Purchased Amount”), in exchange for the purchase price of <u>\$ 20,000.00</u> (the “Purchase Price”).</p> <p>1.2 Intent of the Parties; Transaction Not a Loan. Seller and Purchaser agree that the Purchase Price under this Agreement is in exchange for</p>		<p>provide the Purchaser with the full benefits of ownership of the purchased Future Receivables. It is agreed and acknowledged by the Parties that this purchase and sale transaction has no predetermined repayment term and that the remedies available to Purchaser are those available as a Party to this Agreement for breach of this Agreement and those available as the rightful owner of the purchased Amount of Seller’s Future Receivables. Further, if Seller’s business declines or if Seller’s business enterprise closes in due course, other than as the result of a breach of this Agreement or deliberate acts or omissions by the Seller to frustrate performance of the terms of this Agreement, Seller will not, as a result of such</p>	
Purchase Price	Purchased Percentage	Purchased Receivables	Specified Daily Amount
\$20,000.00	8%	\$26,600.00	\$197.00

Assuming the rest of the contract specifies 30 days in a month, that payments occur every day of the month, and includes no other fees, this computes to an APR of 159%. The calculation is shown below in Figure 17.

Figure 17 - Calculation of APR implied by MCA contract above		
Total Amount of Funds Provided	\$20,000	From contract. ("Purchase Price"). Assuming contract specifies no fees are deducted.
Total Repayment Amount	\$26,600	From contract. ("Purchased Receivables")
Payment Amount	\$197	From contract. ("Specified Daily Amount")
Number of Daily Payments	135.03	= (Total Repayment Amount) / (Payment amount)
Term (in months)	4.50	= (Number of Daily Payments) / (Assumed 30 daily payments per month)
APR	159%	= RATE ((Number of Daily Payments),(Payment Amount as a negative number),(Total Amount of Funds Provided)) x(360 days to annualize the rate)

Many merchant cash advances used today are actually closed-end products, as illustrated in a provider's product description below. If a financing product has fixed payment amounts, it should be treated as closed-end transactions, rather than sales-based transactions, even if it is described as merchant cash advance.

Figure 18 - Often merchant cash advances are actually closed-end products, with fixed payment amounts.²⁸

HOW ARE MERCHANT CASH ADVANCE REPAYMENTS STRUCTURED?



Percent of credit card sales

MCA Loan is paid off via a percentage of your credit card sales taken out until the agreed amount is met.



Fixed daily withdrawals

MCA Loan is paid off via a fixed daily or monthly withdrawal until the agreed amount is met.

Calculating Estimated Term and Estimated APR for Sales-Based Transactions

For sales-based financing we propose a prescriptive Historical Method of calculating these estimates, and a flexible Opt-In Program for providers that believe their own internal method would increase accuracy. We believe the Historical Method proposed is the most accurate than can be used in the absence of reporting to the Department, without risk of gaming by providers. The Opt-In Program provides additional flexibility with gaming mitigated by the additional accountability of reporting to the Department.

²⁸ Merchant Flow, "Merchant Cash Advance," n.d. <https://www.merchantflow.com/services/merchant-cash-advance/>.

A. Historical Method

We propose the Historical Method would calculate Projected Sales Volume by averaging the relevant sales volume over a one-to-twelve month period preceding the financing offer. From this historically-based sales volume, the payments, Estimated Term, and Estimated APR follow.

Relying on this historical data is already the standard calculation approach of sales-based financing providers. Future sales projections, such as found in a pro-forma profit and loss statement, are generally not considered in this industry.²⁹

In this calculation, the sales volume considered includes only the sales channels on which the financing payment amount is calculated. Typically a variable-term product such as merchant cash advance is repaid as a percentage not of all sales, but only of sales through a particular payment channel. This might include all sales processed through Visa, or all payments through a specific payments processor such as First Data. It may not include sales paid to the small business in cash or check, or through a different payments processor. It is important that the disclosure include specifically what sales channels payments will be based on.

We propose that the number of months considered to determine the applicant's average historical sales be set by each individual provider. One provider might choose to estimate historical sales based on nine months, and another provider based on three months. This would be intended to flexibly accommodate the business models of different providers, as some providers may underwrite based on twelve months of sales, while others may only collect data on the previous three months of sales. We suggest this period of historical data used not exceed twelve months. Data that is too aged may be less indicative of the future, and may reduce accuracy. In the case of a growing business, it would reduce the average sales amount calculated, resulting in a lower Estimated APR.

Although providers may select how many months they will base their average sales calculation on, each provider must select a single number of months to use across all of their financing

²⁹ For example, according to Biz2Credit, a leading merchant cash advance provider and lead generator, the documents needed to apply for a merchant cash advance include: "Credit Card Processing Statements, Driver's License, Voided Business Check, Bank Statements, Credit Score, Business Tax Returns." No forward-looking documentation is required. Biz2Credit, "What is a Merchant Cash Advance?" n.d. <https://www.biz2credit.com/business-loan/merchant-cash-advance>.

activities. A provider could not opt to average the previous three months of sales for one applicant and the previous twelve months of sales for another applicant. Permitting this would enable “gaming” on the part of providers, who may select a number of months that results in the lowest sales, thus smallest payments and lowest Estimated APR.

If a given applicant had fewer months of sales activity than the provider’s determined number of sales estimation months, then the provider can use the total number of months since the provider began active sales. For example, if a provider’s determined number of sales estimation months is twelve, and they are considering an applicant who began generating sales only six months before, the provider could use the previous six months only to determine the average monthly sales.

Some merchant cash advance contracts include a penalty sales volume, below which the financing customer incurs a penalty, must pay a higher rate, or must make a minimum payment. If this penalty sales volume is higher than the historical average sales calculated as described above, it should be used as the Projected Sales Volume. For example, a contract may specify that if the customer’s daily sales fall below \$1,000, the split rate increases from 8% to 10% or the borrower pays a \$50 fee. If this customer’s historical daily sales average \$700, because this is lower than the \$1,000 penalty sales volume in the contract, the \$1,000 penalty sales volume would be used as the Projected Sales Volume instead.

If payments on a product are taken daily, the Projected Sales Volume should be measured daily, and used in daily units for purposes of calculating estimates. If payments are taken on weekdays only, only historical sales that took place on weekdays, rather than sales over the whole month, are best included in establishing the Projected Sales Volume.

Calculating payment amounts - As defined by the contracts, the Payment amounts, for a given period, are simply the percentage of sales that go to repayment, often called the “split rate,”³⁰ multiplied by the Projected Sales Volume.

³⁰ Other names for the same concept include “purchased percentage” or “daily percentage.” We recommend the Department utilize a term that makes clear this percentage is not the interest rate, due to the Federal Reserve researcher’s conclusions about this point of confusion. For example, “repayment percentage,” though sometimes used, could give the impression of being an interest rate. The Department may consider that this amount could be expressed as “10 cents of every dollar” rather than “10%” to avoid this confusion.

$$\text{Estimated payment amount} = (\text{Projected Sales Volume}) \times (\text{split rate})$$

For example, if an advance or sales-based loan has monthly payments, projected monthly sales volume of \$100,000, and the financing offer requires 10% of sales to go towards payment of the financing, then \$6,000 will be paid monthly.

However, if the financing offer includes a minimum, specified, or penalty payment amount that is higher than the initial estimated payment amount as calculated above, it would be used instead. For example, one provider's contracts include "Events of Default" for "Failure to comply with the Minimum Payment Requirement." As a second example, in the discussion of Figure 16 above, although the contract specified a split rate of 8%, it also specified a daily payment amount of \$196. If this \$196 is higher than the projected daily sales volume multiplied by the split rate, \$196 would be used as the projected payment amount.

Calculating Estimated Term - Estimated Term is the period of time it will take for the projected payment amounts to add up to the total repayment amount.

$$\text{Estimated Term} = (\text{total repayment amount}) / (\text{estimated payment amount})$$

For example, if the loan or advance has a total repayment amount of \$60,000 and an estimated monthly payment amount of \$6,000, the estimated term calculates to 10 months.

If the financing offer includes a maximum term, or penalty term after which the borrower might incur a fee or other adverse changes, then this should be used as the Estimated Term. For example, if the advance above included a contractual provision that the split rate would increase after 6 months, although the total repayment amount divided by the payment amount equals 10 months, the Estimated Term would be 6 months.

If contractual limits like these result in projected payment amounts that imply a shorter term than the initially Estimated Term, when calculating Estimated APR providers should use a balloon payment at the end of the contractual term.

Calculating Estimated APR - The TILA calculation for closed-end transactions can be used for sales-based transactions, inputting the Estimated Term and Payment Amount. This is the method used in the numerous merchant cash advance APR calculators cited above. As described above, this calculation method can be easily simulated using the “RATE” function in common software programs such as Microsoft Excel and Google Sheets.

Figure 19 - Example calculation of Estimated APR using the Historical Method

	A	B	C
1	Loan Amount	20,000	From contract
2	Total Repayment Amount	25,000	From contract
3	Split Rate	10%	From contract
4	Projected Sales Volume (per day)	1,000	Estimated as the daily average sales over the previous X months
5	Payment Amount	100	=B4*B3
6	# of Payments	250	=B2/B5
7	Estimated Term (in days)	250	=B6
8	Estimated Term (in months)	8.3	=B7 / 30 days in a month as per TILA
9	Estimated APR	66.62%	=RATE(B6,-B5,B1) * 360 days in a year as per TILA to annualize

In developing this proposed Historical Method, we considered more complex calculation options to take into account considerations such as growth trends and seasonality. However, we felt that these options added complexity, perhaps without corresponding benefits. We believe that consideration of sales growth, seasonality, and similar fluctuations in Projected Sales Volume can be best considered through the Opt-In Program discussed below, which combines flexibility with accountability.³¹

³¹ Another option we considered was to base the Estimated Term on the average repayment term of the provider’s historical portfolio over the most recent years. This would have the benefit of being based on real data. While this approach may be appropriate for providers with relatively consistent repayment terms, it would not be for providers with a wide range of repayment terms. As a result, we are not proposing this approach, and raise it only for consideration. It may be an appropriate option for providers with repayment terms that fall within a certain concentration threshold, such as two-thirds of accounts being repaid within 25% of the portfolio’s average repayment term.

B. Opt-In Program

If the sales-based financing provider believes their internal method of determining Projected Sales Volume (and thus the resulting Projected Term, Projected Payment Amount, and Estimated APR) is more accurate, the Opt-In Program provides a way for them to use it.

This method would require that the Projected Sales Volume used by the provider for calculation of the terms disclosed to be the same projection the provider uses internally to underwrite the financing transaction. The provider would represent this to the borrower in the disclosure explanatory language about Projected Payment and Estimated APR, stating “This estimate is based on the projections we used to set the terms of this offer, projecting your sales volume will average [\$_____] per month.”

To join the Opt-In Program, the provider would apply to the Department for authorization to use the Opt-In method. If accepted, they would sign an agreement with the Department. To address the potential for consistent underestimation of disclosed payment amounts and Estimated APR, this agreement would require the provider to report to the Department, on a semi-annual basis or perhaps quarterly basis, the disclosed vs. the actual average Total Payments Per Month and the Estimated APR vs. the Retrospective APR as calculated once the financing has been fully repaid. The Department could thus spend little or no time reviewing the application’s proposed methods, and instead rely on the reporting for accountability. The Department may contemplate other important terms to include in this agreement.

Precedent for this approach exists in the CFPB Trial Disclosure Program created by Dodd-Frank Section 1032(e). Like the Opt-In Program proposed here, the Trial Disclosure Program was created to provide companies flexibility to use a disclosure approach that could increase the effectiveness of the disclosure. Like the Opt-In Program proposed here, it also requires reporting to the regulator the information needed to assess the accuracy of the approach taken.

This Opt-In Program would combine flexibility with accountability for accuracy. The provider’s flexibility enables the consideration of growth trends or seasonality, for example, to the extent that the provider considers these. Once any financing has been fully repaid, the exact payment amounts and dates are known, and so an APR can be calculated exactly, with no estimation required. We propose defining this as the “Retrospective APR.” To calculate the “Retrospective APR,” the exact payment amounts and dates can be used in the closed-end TILA APR calculation methods described in TILA Appendix J.³² More easily, they can be calculated using

³²CFPB, “Appendix J to Part 1026 — Annual Percentage Rate Computations for Closed-End Credit Transactions,” n.d. <https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/J/>.

the “IRR” function of common software such as Microsoft Excel and Google Sheets. Below is an example of one such calculation, demonstrating its simplicity.

Figure 20 - Illustration of the IRR calculation method of Retrospective APR

The IRR calculation simply uses a string of payments that begins with the Total Amount Provided, as a positive number, followed by the payments, as negative numbers. As in any annualized calculation, this is then annualized by multiplying the result by the number of payment that would take place in a year:³³

	A	B	C	D	E	F	G	H
1	RAPR	10.00%	-- The IRR formula here is simply: =IRR(B4:H4)*12					
2								
3	Month	1/1/2018	2/1/2018	3/1/2018	4/1/2018	5/1/2018	6/1/2018	7/1/2018
4	Payment	100,000	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14

This matches the rate that would be calculated using the RATE formula:

	A	B	C	D
6	Loan Amount	100,000		
7	Payment	-\$17,156.14		
8	Term	6		
9	RAPR	10.00%	=RATE(B8,B7,B6)*12	

This IRR calculation also produces the same result as a full amortization table that illustrates a the TILA Appendix J method: (continued below)

³³ When using the IRR formula the time periods between each payment listed should be equal. Thus, if the payments are weekday only, this would be represented by five payments followed by two blank cells, and so on.

	A	B	C	D	E	F	G	H
1	Simple Loan Calculator							
2	Enter values							
3		Loan amount			\$	100,000.00		
4		Annual interest rate				10.00%		
5		Loan period in years				1		
6		Start date of loan				1/11/2019		
7								
8		Monthly payment			\$	17,156.14		
9		Number of payments				6		
10		Total interest			\$	2,936.84		
11		Total cost of loan			\$	102,936.84		
12								
	No.	Payment Date	Beginning Balance		Payment	Principal	Interest	Ending Balance
13	1	2/11/2019	\$ 100,000.00		\$ 17,156.14	\$ 16,322.81	\$ 833.33	\$ 83,677.19
14	2	3/11/2019	\$ 83,677.19		\$ 17,156.14	\$ 16,458.83	\$ 697.31	\$ 67,218.36
15	3	4/11/2019	\$ 67,218.36		\$ 17,156.14	\$ 16,595.99	\$ 560.15	\$ 50,622.38
16	4	5/11/2019	\$ 50,622.38		\$ 17,156.14	\$ 16,734.29	\$ 421.85	\$ 33,888.09
17	5	6/11/2019	\$ 33,888.09		\$ 17,156.14	\$ 16,873.74	\$ 282.40	\$ 17,014.35
18	6	7/11/2019	\$ 17,014.35		\$ 17,156.14	\$ 17,014.35	\$ 141.79	\$ 0.00

TILA provides precedent for retrospective calculation of APR. According to “Truth in Lending: Theory, History, and a Way Forward,” by Thomas A. Durkin, Gregory E. Elliehausen, “There has long been a requirement for disclosure of retroactive, retrospective, historical, or effective APR, calculated post hoc on open-end credit for any period in which a finance charge actually accrues.”³⁴

The Department could determine the interval of the reporting required in the Opt-In Program, such as quarterly or semi-annually. The reporting would include the following fields: an individual account identifier such as an account number, financing amount,³⁵ Projected Payments Per Month, Estimated APR, average Total Payments Per Month calculated retrospectively, and Retrospective APR.

³⁴ This proposed Retrospective APR method also avoids any concerns that have been raised regarding past retrospective APR calculations. Those past methods were designed for disclosures on monthly statements for open-end credit, and so amortize fees into a single billing period. Instead, the proposed Retrospective APR would amortize costs correctly as part of a payment stream of payments over the course of the entire financing, using the IRR formula. This is possible because, unlike the situation contemplated for TILA’s retrospective monthly APR calculation for open-end credit, in this case the financing is fully repaid and so no assumptions need be made about amortization.

³⁵ Including fees, rather than the total amount of funds provided, which omits fees

Figure 21 - Hypothetical reporting of a provider's portfolio to the Department

	A	B	C	D	E	F
			Projected Total		Average Total	
1	Account number	Financing Amount	Monthly Payments	Estimated APR	Monthly Payments	Retrospective APR
2	123456	20,000	2,000	35%	2,400	42%
3	123457	25,000	3,000	33%	2,550	28%
4	123458	15,000	1,000	39%	1,050	41%
5	123459	40,000	5,000	24%	4,750	23%
6	123460	23,000	1,750	21%	2,188	26%
7	123461	30,000	3,000	35%	4,500	51%
8	123462	30,000	2,800	18%	1,400	9%
9	123463	30,000	2,500	40%	3,500	55%
10	123464	30,000	5,000	46%	10,000	83%
11	123465	8,000	3,000	31%	900	11%
12	123466	8,000	600	36%	618	37%

Note that this reporting, by including portfolio data, would be considered trade secret information and so should be protected from Freedom of Information Act requests.

Within the Opt-In Program, if the Estimated APR on a specific transaction differed from the Retrospective APR, this would not result in a regulatory penalty.³⁶ (This may provide comfort to providers interested in the Opt-In Program, and encourage its adoption.)

Accuracy of disclosures would then be considered at the aggregate portfolio level. If the specified portfolio-level accuracy tolerance is not met, the Department could withdraw permission to participate in the Opt-In Program, require further reporting, or consider requiring an examination. If the disclosed Estimated APRs appears to have been calculated in a way that systematically underestimates the Estimated APR, calculated inaccurately in bad faith, or is unreasonably inaccurate, the Department could take enforcement actions under its existing powers with respect to unfair or deceptive acts and practices (“UDAP”).

The Department would define a tolerance, within the Opt-In Program, for how the portfolio average Retrospective APR may differ from the portfolio average Estimated APR disclosed.

Although the accuracy of estimations on a single account may be notably high or low in extreme circumstances, at the portfolio level the estimations should be considerably more accurate. While some businesses may repay more quickly, leading to a higher-than estimated APR, some will repay more slowly, and a certain amount of balance should occur.

³⁶ Exceptions, of course, might include occurrences of bad faith, or inaccurate application of the calculation methods.

Consider some extreme examples in the hypothetical portfolio reported in Figure 21 above. This portfolio includes a borrower who grew by 345% annually beyond any growth estimate considered in the Estimated APR. And it included borrowers whose sales declined an extreme degree—90% decline beyond anything projected in the calculation of Estimated APR. For the business that grew by the more than three times annually beyond the projection, the Estimated APR was 44% lower than the actual Retrospective APR.³⁷ For the business that shrank -90% beyond the projection, the Estimated APR was 173% higher than the Retrospective APR.³⁸ For the portfolio overall, these washed out. The portfolio average Retrospective APR turned out to be 13% lower than the Estimated APR that would have been disclosed. Presumably having a lower actual APR than originally disclosed would presumably not result in regulatory penalty.

For purposes of assessing the accuracy of disclosure estimates, non-performing financing (such as charge-offs or defaults) should not be included. Including financing that proved unaffordable to the borrower would have the adverse result of providing leeway for underestimation of APR for performing borrowers. This is because non-performing accounts will have longer repayment terms because of nonpayment, which would appear as a lower Retrospective APR. Thus, if defaults were included, the more defaults in a provider's portfolio, the more the disclosed Estimate APR could fall below the actual Retrospective APR. This can be easily prevented by excluding non-performing financing from the portfolio average Retrospective APR calculation.

³⁷ Estimated APR of 46% was disclosed. Because significantly higher than anticipated growth shortened the term, Retrospective APR calculated to 83%.

³⁸ Estimated APR of 31% was disclosed. Because catastrophic decline in sales lengthened the term, Retrospective APR calculated to 11%.

VII. Commercial Open-End Credit Plans: Calculating Estimated APR

Lines of credit are the common form of open-end financing.³⁹ To achieve the two goals of comparability and informed consent, open-end products are best considered with an Estimated APR that incorporates the cost of fees. Such an estimated APR can be calculated utilizing the method for closed-end transactions, if the following two assumptions are stipulated:

- 1) The financing is immediately drawn once to the maximum amount, and
- 2) The draw is repaid based on the minimum payment

With this method of calculation, open-end products can be compared with a much greater measure of accuracy to other types of financing options a small business may consider.⁴⁰ For purposes of calculation of Estimated APR, the term used would be determined by when the initial draw is fully repaid based on minimum payments. For disclosure purposes, the disclosed Term is the period during which the open-end line remains open.

We considered recommending that open-end products be calculated according to the method described in Regulation Z, 12 C.F.R § 1026.14, which implements Section 107 of TILA. However, this provision of Regulation Z has been much-maligned for the loopholes it has created in consumer lending.⁴¹ The problem is that fees are not included in the APR. For open-end products, the APR is identical to the period interest rate.⁴²

This provision of Regulation Z can be gamed, and it is being gamed. Consumer advocates point to a popular open-end credit product that structures its financing charges entirely as fees. As a result, under the existing TILA rules it discloses an APR of 0%.

This problem has been anticipated in industry proposals for transparency. Indeed, the Small Business Borrowers' Bill of Rights requires fees to be included in the APR using the assumptions described above. The Small Business Borrowers Bill of Rights Attestation Worksheet for Lenders and Marketplaces specifies that: "For lines of credit and other open-end types of financing, rates must be calculated with reasonable assumptions about use, including

³⁹ Sometimes advancing term loans are called "non-revolving" lines of credit. Advancing term loans are loans which can be drawn down in multiple draws. Unlike a traditional open-end line of credit, the balance does not become available to draw again after it is repaid. For purposes here, they can be considered closed-end transactions, and all calculations performed on the full amount of the loan.

⁴⁰ An alternative assumption set we considered would be to assume that the outstanding balance will be the average utilization percentage of the providers entire portfolio of open-end credit, and that fees are assumed to be the average fees charged, as a percentage of outstanding balances, for the same portfolio. This approach may also have merit.

⁴¹ For example, a letter to the CFPB from the National Consumer Law Center writes, "If the CFPB chooses to revisit the open-end credit provisions of Regulation Z, we urge it to... close loopholes that omit fees from the finance charge and APR." See page of the following letter dated June 25th, 2018:
<https://www.nclc.org/images/pdf/rulemaking/cfpb-inherited-regs-tila-respa-mortg.pdf>.

⁴² While TILA itself requires the inclusion of fees in open-end credit, the current form of Regulation Z does not. See above cited June 25th, 2018 letter by National Consumer Law Center.

assuming the borrower draws the full amount on the origination date, and makes the minimum payments required.” The SMART Box also includes fees in the calculation of APR for lines of credit. One provider, a larger small business financing company and one of the creators of the SMART Box, describes its product as a line of credit. This provider offers an example SMART Box on its website, showing fees included in its calculation of APR:

Figure 22 - Excerpt from SMART Box example⁴³

Metric	Metric Calculation	Metric Explanation
<p>Total Cost of Capital</p> <p>\$16,875</p>	<p>Interest Expense: \$0.00</p> <p>Loan Fee: \$16,875.00</p> <p>Origination Fee: \$0.00</p> <p>Other Fees: \$0.00</p> <hr/> <p>Total Cost of Capital: \$16,875.00</p>	<p>This is the total amount that you will pay in interest or Loan Fees and other fees for the Loan.</p> <p>The amount does not include fees and other charges you can avoid, such as late payment fees and returned payment fees.²</p>
<p>Annual Percentage Rate (APR)³</p> <p>40.46%</p>	<p>Your Loan will have monthly payments of: See Specific Monthly Schedule Below</p> <hr/> <p>APR: 40.46%</p>	<p>This is the cost of the Loan - including total interest or Loan Fees and other fees - expressed as a yearly rate. APR takes into account the amount and timing of capital you receive, fees you pay, and the periodic payments you make.</p> <p>While APR can be used for comparison purposes, it is not an interest rate and is not used to calculate your interest expense or Loan Fee.</p>

As you can see, this provider considers all of its finance charges to be fees, not interest. If this product were treated with the existing Regulation Z treatment for open-end credit, it would disclose an APR of 0%.

The federal Credit CARD Act offers a precedent for use of the assumptions of minimum payments and use of the full credit line in consideration of open-end credit. See Regulation Z, 12 C.F.R. § 1026.51(a)(2)(ii). As described in the Federal Reserve’s Consumer Compliance Outlook, “Section 226.51 requires issuers to consider repayment ability for the required minimum periodic payments... The rule includes a safe harbor if the issuer calculates the

⁴³ Kabbage, “SMART Box Capital Comparison Tool,” n.d. <https://www.kabbage.com/smart-box/>.

minimum payment based on the full credit limit, mandatory fees, and any expected interest rate.”
44

Although referring to Regulation Z for open-end credit might seem simpler, California can “get it right” where others have failed by utilizing the assumptions proposed to produce an Estimated APR calculation that truly enables informed comparison by including the cost of fees.

⁴⁴ Consumer Compliance Outlook, An Overview of the Regulation Z Rules Implementing the CARD Act,” 2010.
“<https://consumercomplianceoutlook.org/2010/first-quarter/regulation-z-rules/>”

VIII. Factoring and Asset-Based Lending Transactions with Master Financing Agreements

In a standard factoring transaction, the factor advances the small business about 80-85% of an unpaid invoice upfront. When the small business's client pays the invoice, the small business receives the remaining amount of the invoice, minus a factoring fee. A typical factoring fee is about 0.5% – 4% per month.⁴⁵

Factoring products and similar products are already described in the market today using APR:

Figure 23 - Example of factoring products and similar products quoted in APR⁴⁶

Lender	APR [?]	Min credit score	
 BlueVine View details	14-68% Estimated APR*	530 Min credit score	Apply Now  on BlueVine's secure website
 FUNDBOX View details	16.5-76.5% Estimated APR*	None Min credit score	Apply Now  on Fundbox's secure website

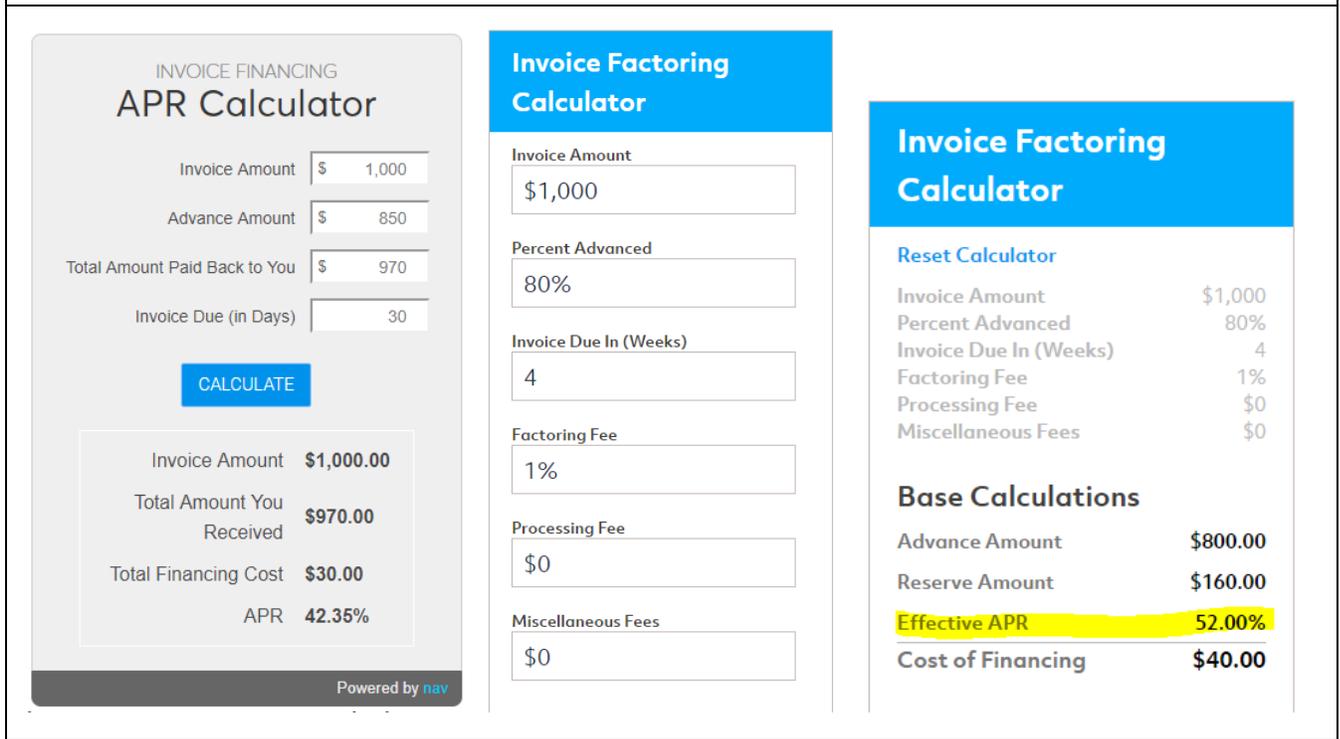
In effect, factoring behaves like a single-payment loan. The borrower receives proceeds (called the advance amount instead of the loan amount), and then makes a single payment when the invoice is repaid. The amount of this payment is the full invoice amount that now goes to the factoring provider rather than the small business, minus the amount the factoring provider gives the small business when the invoice is paid off.

Calculators offered online today help small businesses calculate the Estimated APR of the factoring products that they may be considering, or using already.

⁴⁵ Nav, "Invoice Financing APR Calculator," n.d. <https://www.nav.com/business-loan-calculators/invoice-financing-apr-calculator/>.

⁴⁶ NerdWallet, "Small Business Loans: Compare Financing," n.d. <https://www.nerdwallet.com/small-business-loans>.

Figure 24 - Examples of online APR calculators for factoring products⁴⁷



In the example in the grey calculator above, the small business is advanced \$850 upfront for a \$1,000 invoice. When the invoice is paid, the factor gives the small business the remaining value of the invoice, minus the amount already advanced, and the finance charge. That's $(\$1,000 \text{ invoice amount}) - (\$850 \text{ advance amount}) - (\$30 \text{ finance charge}) = (\$120)$, which is often called the “rebate”). The factor keeps \$880, which is the invoice amount the rebate amount. This \$880 functions as the payment amount paid by the borrower.

Regulation Z describes the APR calculation for this situation in its section on “Single advance, single payment transaction,” in Appendix J.⁴⁸

The Nav calculator walks through this math: “The math is actually quite simple since there's only one advance and one payment. First, let's calculate the interest charge you end up paying. Interest

⁴⁷ Nav, “Invoice Financing APR Calculator,” n.d.

<https://www.nav.com/business-loan-calculators/invoice-financing-apr-calculator/>. Fundera, “Invoice Factoring Calculator: What Can You Afford?” 2018. <https://www.fundera.com/business-loans/business-loan-calculators/invoice-factoring-calculator>. Additional explanation at: Excelsior Growth Fund, “Business Loans for Small Business: True Cost of Factoring as a Short Term Business Loan,” n.d. https://www.excelsiorgrowthfund.org/business_resources/True-Cost-of-Factoring-as-a-Short-Term-Business-Loan_78_resource.htm.

⁴⁸ CFPB, “Appendix J to Part 1026 — Annual Percentage Rate Computations for Closed-End Credit Transactions,” n.d. <https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/J/#c-9>.

= (Invoice Amount) - (Total Amount Paid Back to You). Next, let's calculate the monthly rate. We assume there are 30 days in a month. (Monthly Interest Rate) = ((Interest + (Advance Amount))/(Advance Amount))^(30/(Invoice Due in Days)) - 1. Then the *APR* = (Monthly Interest Rate) (12). We assume monthly compounding here. Some other calculators may use daily compounding. Their APR will be slightly higher. We choose monthly compounding because you can make direct comparisons with a term loan, with a credit line from a bank or with a credit card.”

Like the other APR calculations discussed in this letter, it can be performed using common software including Microsoft Excel and Google Sheets. Below is the calculation of the example above, using the “RATE” function.

Figure 25 - APR calculation for factoring example

	A	B	C
1	Invoice Amount	\$ 1,000	
2	Advance amount (%)	85%	
3	Advance Amount (\$)	\$ 850	
4	Factoring fee (%) per period	3%	
5	Factoring fee (\$) per period	\$ 30	
6	Months until invoice is paid	1	
7	Rebate amount	\$ 120	
8	Effective payment amount	\$ 880	=B1-B7
9	Periods per year	12	
10	APR	42.35%	=RATE(B6,-D14,B3)*B9

The only additional information needed to complete this calculation is the term. Fortunately, there is clear grounding for how this term should be established. It is written on the invoice.

To estimate the term, the provider can simply use the due date on the invoice. For example, if the invoice is due in 45 days, the Estimated Term would be 45 days.

A second option that could be considered would be to allow the provider to rely on their historical data for the rate of repayment from a particular vendor. For example, if the provider regularly factors invoices repayable by Acme Wholesale, and finds that Acme Wholesale on average repays these invoices in 65 days, even though the invoice itself may specify that payment is due in 30 days, the factoring provider may use 65 days as the Estimated Term. The Department may consider whether offering a provider this discretion in establishing term should

require reporting to ensure that the discretion is not abused, as in the Opt-In Method described in the sales-based transactions section above.

For a master financing agreement, through which multiple invoices may be factored, an Estimated APR can be calculated using a similar approach to open-end credit. That is, make standardized reasonable assumptions for a single instance of use of the agreement to calculate Estimated APR. In this case, assume the financing agreement is fully utilized on the date it is opened, and the Estimated Term as described above.

Some providers offer invoice financing products that appear similar to invoice factoring, but with respect to calculation of terms are in fact closer to closed-end or open-end financing. For example, one invoice financing providers offering: “advances 100% of the invoice’s value upfront, and you repay it in 12 or 24 equal weekly installments, plus a fee.”⁴⁹ In this case, the term need not be estimated and the exact payment amounts are known. This product would be considered a commercial open-end credit plan, not factoring. The Estimated APR would be calculated using the methods described for open-end financing.

Additionally, SB 1235 permits some disclosures to include examples illustrating the cost of hypothetical transactions. The Department should define a fixed dollar amount used for these hypotheticals, so that small businesses can compare them effectively. We suggest that \$10,000 be the standard used here.

⁴⁹ NerdWallet, “Invoice Factoring: Financing for Your Small Business,” 2018.
<https://www.nerdwallet.com/blog/small-business/small-business-invoice-factoring/>.

IX. APR Calculation and Standardized Time Periods

As under the federal TILA, we recommend the DBO consider allowing the assumption that all months have 30 days, and all years 360 days, for ease of calculation.⁵⁰

For products with weekday-only payments, we also suggest that for ease of calculation providers be given the option, when calculating APR, of assuming that payments are spread evenly across the year rather than five days in a row followed by two weekend days of no payments. Below is a calculation illustrating the weekday-only payment calculation method for either approach, indicating that the difference is negligible in the APR calculation that results. If payments are measured by the calendar (assuming 360 days), the APR computes to 47.93%. If payments are assumed to be spread evenly, the APR computes to 47.59%.

⁵⁰CFPB TILA Laws and Regulations: “360-Day and 365-Day Years – Section 1026.17(c)(3) - Confusion often arises over whether to use the 360-day or 365-day year in computing interest, particularly when the finance charge is computed by applying a daily rate to an unpaid balance. Many single payment loans or loans payable on demand are in this category. There are also loans in this category that call for periodic installment payments. Regulation Z does not require the use of one method of interest computation in preference to another (although state law may). It does, however, permit financial institutions to disregard the fact that months have different numbers of days when calculating and making disclosures. This means financial institutions may base their disclosures on calculation tools that assume all months have an equal number of days, even if their practice is to take account of the variations in months to collect interest.” https://files.consumerfinance.gov/f/201503_cfpb_truth-in-lending-act.pdf

Figure 26 - Illustration of APR calculation methods for weekday payments

	A	B	C	D	E	F	G	H
1	Loan Amount	20,000	From contract					
2	Total Repayment Amount	25,000	From contract					
3	Split Rate	10%	From contract					
4	Projected Avg Weekday Sales	1000	Estimated					
5	Payment Amount	100	=B4*B3					
6	# of Payments	250	=B2/B5					
7	Estimated Term (in weekdays)	250	=B6					
8	Avg Weekdays/year	257.14	= 360 days in a year / 7 days in a week * 5 weekdays in a week					
9	Days/year	360	Assumed					
10	Estimated Term (in days w/ wknds)	350	=B7/B8*B9					
11	Estimated Term (in months)	11.67	=B7/B8*12 months in a year					
12	APR (assuming weekday pmts spread evenly over the month)	47.59%	=RATE(B6,-B5,B1)*B8					
13								
14	APR (based on an actual calendar of 5 weekday payments followed by no payments on weekends.)	47.93%	=IRR(C16:C366)*360					
15		Day #	Payment					
16		0	-20,000					
17		1	100					
18		2	100					
19		3	100					
20		4	100					
21		5	100					
22		6	0					
23		7	0					
24		8	100					
25		9	100					
26		10	100					
27		11	100					
28		12	100					
29		13	0					
30		14	0					
31		15	100					

X. Reliance Upon Internal Underwriting Criteria to Calculate Estimated Terms and Estimated Annualized Rates

We believe the internal underwriting criteria to should be used in calculating estimates for disclosures, provided that there is sufficient accountability to mitigate the risk of “gaming” these disclosures. This is what we have proposed in the Opt-In Program.

We considered permitting use of internal underwriting criteria for disclosure purposes outside of a relationship of accountability with the Department, but were concerned that flexibility may be abused.

Within the Opt-In Program, providers would use their internally generated Projected Sales Volume to calculate Estimated Term and Estimated APR. The providers enter into a relationship with the Department, including reporting on the accuracy of these estimates, to create accountability.

XI. Prepayment Policies

Transparency of prepayment policies is especially important due to the growth of hidden prepayment charges. Hidden prepayment charges can occur when financing with a fixed fee is paid off early, but the financing fee is nonetheless charged on the unused portion of the term.

Some financing products now offered require a fixed repayment amount that is due (in full or in large part), regardless of when the borrower repays. For example, a \$50,000 loan might include a \$10,000 fixed fee and a term of 12 months. If the borrower pays on schedule over 12 months, they pay a financing charge of \$10,000. If they repay in one day, they still pay a financing charge of \$10,000.

For these products, it is not possible for borrowers to save money by prepaying. Nonetheless, some providers may advertise that there is “no prepayment penalty,” although there is effectively a prepayment charge because the borrower must pay the full finance charge when they prepay, even if they used only a part of the financing.

Some providers offer a partial discount during prepayment, such as a 25% “prepayment savings.” This may give the impression of prepayment terms more favorable than a traditional loan, when in fact the 25% prepayment savings is akin to a 75% prepayment charge.

Small business owners, like consumers, may often believe that if they pay off financing early they will save money. If that’s not the case, this should be very clear.

To provide this clarity and accomplish the goals of SB 1235, we propose the following language be required for disclosure of prepayment policies:

[Yes] / [No] - If you pay off the financing before the [Estimated] Term, will you be required to pay finance charges other than interest since your last payment?

[If Yes] The finance charge due at payoff could be as high as [\$_____].

[Yes] / [No] - Does paying off ahead of the [Estimated] term result in any additional fees or charges, not already included in the Finance Charge?

[If Yes] The additional fees could be as high as [\$_____].

An example below describes a traditional term loan.

Example A: Prepayment disclosure for a closed-end loan with a finance charge of \$10,000, including a \$600 origination fee and \$9,400 in interest, and no prepayment fee.

~~[Yes]~~ / **[No]** - If you pay off the financing before the Term, will you be required to pay finance charges other than interest since your last payment?

~~[Yes]~~ / **[No]** - Does paying off ahead of the Term result in any additional fees or charges, not already included in the Finance Charge?

A second example below describes a loan which, without proper disclosure, could be considered to have a hidden prepayment charge. In this second example, the finance charge due at payoff could be as high as \$7,050. This is the \$9,400 fixed financing charge, minus the 25% prepayment discount.

Example B: Prepayment disclosure for a fixed-fee, closed-end loan with a finance charge of \$10,000, including a \$600 origination fee and a \$9,400 in fixed fee, a 25% prepayment discount, and no additional prepayment fee.

[Yes] / ~~[No]~~ - If you pay off the financing before the Term, will you be required to pay finance charges other than interest since your last payment?

The finance charge due at payoff could be as high as [\$7,050].

~~[Yes]~~ / **[No]** - Does paying off ahead of the Term result in any additional fees or charges, not already included in the Finance Charge?

For sales-based transactions, which do not have a fixed term, prepayment may be a consideration when a small business customer seeks to pay off the financing ahead of regular process. For example, as opposed to continuing to repay automatically as a percentage of sales, the small business may contact the provider and ask to pay off the remaining financing by making a payoff payment or sending a check. A sales-based financing provider would complete the proposed prepayment policy disclosures considering this scenario.

The Department should also not permit the language used to describe prepayment policies to give misleading impressions. Specifically, a product should not be permitted to be described as having “no prepayment fee” or “prepayment savings” if the provider would answer “Yes” to the first question above: “If you pay off the financing before the [Estimated] Term, will you be required to pay finance charges other than interest since your last payment?”

XII. “Double Dipping” and Calculation of APR and Amount of Funds Provided

To correctly portray the cost of financing, the Department’s regulations must consider the potentially deceptive and abusive practice called “double dipping.” Double dipping involves a provider effectively double-charging a small business when refinancing or renewing their financing.

Double dipping occurs when a small business refinances or renews their financing with their current provider, and the proceeds from the new loan or advance is used to pay off the balance from the previous loan or advance, including any unpaid or un-accrued interest or fees. In this way, the provider charges the borrower the same fixed-fee twice for the balance that was outstanding. The fixed fee is charged once as the outstanding balance is paid off, and then a second time for the same capital in the renewal.

This can be difficult to follow, which is why many small business owners may not realize they are being double-charged.

Figure 27 - Screenshot from a financing provider’s video illustrating double dipping. Helpful industry explanations of double dipping can be found in the links footnoted below.⁵¹



⁵¹ Educational advertisement videos by merchant cash advance provider illustrating double dipping: The Business Backer, “Double Dipping,” 2014. <https://www.youtube.com/watch?v=k62kCK5tZwo>.

The same provider describes the practice further here:

The Business Backer, “Double Dipping,” n.d. <https://www.businessbacker.com/double-dipping/>.

A related provider offers a double dipping calculator here:

Breakout Finance, “Double Dipping Explained,” n.d. <https://www.breakoutfinance.com/double-dipping-explained/>.

To illustrate, consider the example in Figure 28, below. A small business has taken a 12-month loan of \$100,000 and a fixed fee of 20%. They will repay \$120,000 in total. In the 6th month, the provider's sales team calls the small business and offers a renewal of the same loan. It sounds like the same deal. However, \$70,000 of the new loan must go to pay the outstanding balance of the earlier loan, including the 20% fixed fee on that financing. The small business then gets only \$30,000 in new capital, but is then charged a fixed fee of 20% on the full \$100,000 loan amount. The borrower is "double dipped." This practice has the effect of significantly increasing the effective yields the provider obtains, and the effective APRs the borrower pays.

Figure 28 - Double dipping increases the provider's yield, and the borrowers' effective APR

	D	E	F	G	H	I
1		First loan, if paid as scheduled	First loan, if prepaid after 6mo at full fee	Second loan, without considering double dipping	Both loans together, including double dipping	Now the borrower takes a third loan in month 12, and is double dipped again
2	Estimated APR >	35%	48%	35%	41%	44%
3	Formula	=IRR(E4:E16)*12	=IRR(F4:F10)*12	=IRR(G10:G22)*12	=IRR(H4:H22)*12	=IRR(I4:I28)*12
4	Month \/					
5	0	100,000	100,000		100,000	100,000
6	1	(10,000)	(10,000)		(10,000)	(10,000)
7	2	(10,000)	(10,000)		(10,000)	(10,000)
8	3	(10,000)	(10,000)		(10,000)	(10,000)
9	4	(10,000)	(10,000)		(10,000)	(10,000)
10	5	(10,000)	(10,000)		(10,000)	(10,000)
11	6	(10,000)	(70,000)	100,000	30,000	30,000
12	7	(10,000)		(10,000)	(10,000)	(10,000)
13	8	(10,000)		(10,000)	(10,000)	(10,000)
14	9	(10,000)		(10,000)	(10,000)	(10,000)
15	10	(10,000)		(10,000)	(10,000)	(10,000)
16	11	(10,000)		(10,000)	(10,000)	(10,000)
17	12	(10,000)		(10,000)	(10,000)	30,000
18	13			(10,000)	(10,000)	(10,000)
19	14			(10,000)	(10,000)	(10,000)
20	15			(10,000)	(10,000)	(10,000)
21	16			(10,000)	(10,000)	(10,000)
22	17			(10,000)	(10,000)	(10,000)
23	18			(10,000)	(10,000)	(10,000)
24	19					(10,000)
25	20					(10,000)
26	21					(10,000)
27	22					(10,000)
28	23					(10,000)
29	24					(10,000)

In the example above, double dipping causes the effective APR of the series of loans to increase from 35%, to 41% in the first instance double dipping, and to 44% the second time.

Fortunately, the cost of double dipping can be calculated and accurately disclosed to a small business at the point when they are considering a new offer of financing that would double dip them.

First, funds required to repay the outstanding balance on financing from the same provider should not be included in the "Amount of Funds Provided." After all, funds that are withheld by a provider,

whether for an origination fee or refinancing an existing account, are not “provided.” This is the case whether the outstanding loan will be repaid by new funds from the provider, or by other funds the borrower obtains elsewhere. (Similarly, funds disbursed to a related entity of the provider should also not be included, to prevent related-entity loopholes.)

Second, the APR or Estimated APR calculation should reflect the cost of the double dipping. To perform this calculation, we suggest that the APR or Estimated APR be calculated for the complete string of financing from the same provider, including previous financing that was also double dipped. This previous string would go back until a point when the borrower held no financing with the provider that was repaid as a condition of subsequent financing.

The APR of a series of loans or advances can be calculated using the internal rate of return computation, which can be performed using the “IRR” formula in common software such as Microsoft Excel and Google Sheets.⁵²

Row 3 in the figure above shows the calculation used. In these example, all payments between the provider and small business are considered, going back to the origination of the first loan or advance that was double dipped. Fees are also included. The amount of of funds provided appears as a positive number, and the payments and fees paid by the small business appear as negative numbers. This is then annualized by multiplying it by the number of payments in a year.⁵³

This approach incorporates the calculation method of Retrospective APR, for all payments and fees that have already taken place, and the appropriate APR or Estimated APR calculation for the new financing being considered.

⁵² The XIRR formula can also be used. This allows the computation to include the specific dates when payments or charges occurred. Because the IRR formula requires equal periods of time between each cell, XIRR may be simpler for calculations including uneven period of time between payments, such as weekday only payment products. The XIRR formula calculate the actual 365 day calendar. If an APR calculated using XIRR needed to be compared to an APR calculated assuming a 360 day calendar, additional calculations can be provided. This may be helpful if comparing Estimated APR to Retrospective APR, for example.

⁵³ In this case, the result is multiplied by 12 to annualize it because there are 12 monthly payments in a year. If the payment period was daily, this would be multiplied by 360 or 365.

XIII. Tolerances

Providers calculating an Estimated APR using the prescribed Historical Method should arrive at the correct number if they employ the method correctly. With respect to the accuracy of the calculation, it may be appropriate to provide the tolerance allowed under TILA to account for small differences in rounding. The TILA APR rules allow for an error of 1/8th of a % for regular transactions, and 1/4 of a % for irregular transactions.⁵⁴

Within the Opt-In Program, the same standard would apply for the calculation itself. The Department would define a tolerance for the accuracy of the Estimated APR as a predicted of the Retrospective APR.

⁵⁴ 15 U.S.C. § 1606(c); Reg. Z § 1026.22(a)(2-3).
<https://www.govinfo.gov/content/pkg/USCODE-2009-title15/html/USCODE-2009-title15-chap41.htm>.

XIV. Fees and Charges Included in an APR Calculation

We suggest that the Department utilize Regulation Z, implementing the Truth in Lending Act, to determine what fees and charges should be included in APR. In addition, the Department should require inclusion of the additional charges and fees identified for inclusion in APR under the Military Lending Act and any subsequent amendments thereto.

Section 1026.4(a) of Regulation Z explains that the finance charge, and thus the fees included in APR, “includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit.”⁵⁵ If a fee must be paid in order to use the financing, that is to say, the fee is “an incident to a condition of” the financing, then it should be included.

The table below displays “Interagency Examination Procedures for Regulation Z,” which may be helpful for identifying finance charges. In a 2017 Federal Reserve Consumer Compliance Outlook article, this chart was printed with a note that it is “neither is exhaustive nor exclusive, nor does either substitute for the regulation or Official Staff Commentary (commentary).”⁵⁶ The chart categorizes charges into several categories: 1) some charges that are always included in the finance charge, 2) some that are always excluded, 3) some that may be excluded if certain conditions are met, and 4) some that are excluded with respect to credit secured by real property or in a residential mortgage transaction (even though they would be considered finance charges in other types of credit transactions). This can provide a helpful framework for thinking about how charges should be included in the finance charge and when to exclude them.

⁵⁵ CFPB, “§ 1026.4 Finance Charge,” n.d. <https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/4/>.

⁵⁶ Consumer Compliance Outlook, “Understanding Finance Charges for Closed-End Credit,” 2017. <https://www.consumercomplianceoutlook.org/2017/first-issue/understanding-finance-charges-for-closed-end-credit/>.

Figure 29 - Finance Charge Chart

TABLE 1: Finance Charge Chart

Finance Charge = Dollar Cost of Consumer Credit: It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as a condition of or incident to the extension of credit.				
Charges Always Included	Charges Included Unless Conditions Are Met	Conditions (any loan)	Charges Not Included (residential mortgage transactions and loans secured by real estate)	Charges Never Included
Interest	Premiums for credit life	Insurance not required, disclosures are made, and consumer authorizes	Fees for title insurance, title examination, property survey, etc.	Charges payable in a comparable cash transaction
Transaction fees	Debt cancellation fees	Coverage not required, disclosures are made, and consumer authorizes	Fees for preparing loan documents, mortgages, and other settlement documents	Fees for unanticipated late payments
Loan origination fees; consumer points	Premiums for property or liability insurance	Consumer selects insurance company and disclosures are made	Amounts required to be paid into escrow, if not otherwise included in the finance charge	Overdraft fees not agreed to in writing
Credit guarantee insurance premiums	Premiums for vendor's single interest (VSI) insurance	Insurer waives right of subrogation, consumer selects insurance company, and disclosures are made	Notary fees	Seller's points
Changes imposed on the creditor for purchasing the loan, which are passed on to the consumer	Security interest charges (filing fees), insurance in lieu of filing fees and certain notary fees	The fee is for lien purposes, prescribed by law, payable to a third public official and is itemized and disclosed	Preconsummation flood and pest inspection	Participation or membership fees
Discounts for inducing payment by means other than credit	Charges imposed by third parties	Use of the third party is not required to obtain a loan, and creditor does not retain the charge	Appraisal and credit report fees	Discount offered by the seller to induce payment by cash or other means not involving the use of a credit card
Mortgage broker fees	Charges imposed by third-party closing agents	Creditor does not require and does not retain the fee for the particular service		Interest forfeited as a result of interest reduction required by law
Other examples: Fee for preparing TILA disclosures; real estate construction loan inspection fees for postconsummation tax or flood service policy; required credit life insurance charges	Appraisal and credit report fees	Application fees, if charged to all applicants, are not finance charges; application fees may include appraisal or credit report fees		Charges absorbed by the creditor as a cost of doing business

Source: Federal Financial Institutions Examination Council (FFIEC) Rev. 5/2011

The Department should consider the Military Lending Act's improvements on this categorization, which were designed to plug three small loopholes that have been identified in the fee inclusion rules of Reg Z. The Military Lending Act calculation of the Military APR (MAPR) additionally requires inclusion of a) application fees, b) fees like overdraft fees that could occur in a cash transaction, and c) fees for add-on products such as credit insurance.⁵⁷ Not including these fees in the APR would encourage lenders to shift fees to the type of fees that are not disclosed in the APR.

Below is a list of some of the fees charged for online small business lending products, indicating our assessment of whether they would be included in an APR calculation. This list draws on the fees identified in the Woodstock Institute's Analysis of Online Loan Terms as currently being charged in the small business credit market.⁵⁸

- Financing fee (paid over the course of the financing, as a % of receivables) - Included
- Origination fee (deducted from proceeds) - Included
- Upfront fee (deducted from proceeds) - Included
- Administrative fee (paid monthly) - Included
- Maintenance fee (paid monthly) - Included
- ACH fee (charged per payment) - Included
- Pay by check fee - Included, as per Regulation E
- Risk Assessment Fee - Included, as an application fee, as per Military Lending Act
- Credit Insurance Fee - Included, as per Military Lending Act
- UCC Fee (charged at origination for UCC filing) - Included
- Servicing or processing fee (paid upfront, or as a % of the payment amount) - included
- Referral Fee (charged upfront, as a requirement of being referred to a partner provider to get a loan) - Included
- Undrawn Balance Fee (charged on undrawn balances in open-end credit) - Included
- Packaging fee (charged upfront for help preparing an application before submission) - If required, included. If optional, not included.
- Wire fee - If optional, not included
- Prepayment Fee - Not included
- Late Fee - Not included
- NSF or unsuccessful payment fee - Not included
- Collections fees - Not included

⁵⁷ 32 CFR 232.4(c)(1). One useful summary of the fees that should additionally be included under the Military Lending Act can be found on pages 24-25 of the Federal Reserve Military Lending Act Examination Procedures.

https://www.federalreserve.gov/supervisionreg/caletters/Attachment_CA_Letter_16-6_MLA_Exam_Procedures.pdf

A second resource may be the OCC's Military Lending Act Comptroller's Handbook:

<https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/military-lending-act/pub-ch-mla.pdf>

⁵⁸ Woodstock Institute, "Analysis of Business Loan Terms," n.d.

http://www.woodstockinst.org/wp-content/uploads/2016/07/Woodstock_Analysis_of_Online_SB_Loan_Terms.pdf.

XV. Disclosure of Method, Frequency, and Amount of Payments

Today, it can be difficult for small businesses to make clear comparisons between the payments that will be charged by products offered with daily, weekly, bi-weekly, and monthly payments. To enable comparison by standardizing the time period, disclosures must include the dollar amount of payments that will occur with a month.

If there is a single payment each month, the provider must disclose “Monthly Payment.” If the payment amount is other than monthly, the provider would disclose “Total Payments Per Month.” In the case of sales-based transactions, this would be called “Projected Payments Per Month,” and be calculated based on the Projected Sales Volume.⁵⁹

For sales-based products, a disclosure such as “X% of monthly sales through XYZ payment processing platform,” alone does not provide sufficient transparency. It does not enable a small business to make informed comparison with a financing that may simply quote “\$947 per month,” or “Y% of ABC payments processing platform.”

In addition to the Total Payments Per Month amount, providers should include the amount and timing of payments other than fixed and monthly in the explanatory text. If the payment amount is other than monthly, this might say, “You will pay \$197 every weekday.” If the payment amount is based on sales, the explanatory text might say, “Every weekday, you will pay 10% of daily sales through XYZ payment processing platform. We estimate that be about \$100 per weekday, based on projected daily sales of \$1,000.”

If the payment amounts are known but different, as in the case of closed-end transactions with larger payments charged upfront, it could be permissible to disclose a single average Total Payments Per Month, and a breakdown of the specific payments that would be charged.

⁵⁹ (Projected Sales Volume per months(X (Spit Rate) + expected fees = Projected Payments Per Month

Figure 30 - Example of a provider disclosing Average Monthly Payment

<p style="text-align: center;">Average Monthly Payment</p> <p style="text-align: center; color: green; font-size: 1.2em;">\$7,656.25</p>	<p>Repayment Amount: \$91,875.00</p> <p>Term (in months): + 12 Months</p>	<p>This is the average monthly repayment amount of the Loan, which does not include fees and other charges you can avoid, such as late payment fees and returned payment fees.² This is an estimate for comparison purposes only.</p>
	<p>Average Monthly Payment: \$7,656.25</p>	
	<p>Specific Monthly Schedule</p> <p>Months 1-6: \$8,125.00</p> <p>Months 7-12: \$7,187.50</p>	

Although this includes an average monthly payment, the calculation of APR should not use this average, and should instead be based on the actual payment amounts. Using the average would have the effect of inaccurately reducing the APR.

Total Payments Per Month should include fees or other charges that are anticipated and unavoidable, such as a monthly account maintenance fee.

In the case of sales-based products, the disclosures should clearly identify what sales channels the payment will be based on. For example, “10% of sales through payment processor.”

XVI. Explanatory and Qualifying Language in Connection with Estimated Term and Estimated Annualized Rates

Below is suggested language or description requirements for each of the required terms. Requirements for specific language would ideally be market-tested, prior to implementation, to ensure they are sufficiently well understood.

Item	Proposed explanatory language or description requirements
Amount of Funds Provided	“This is your financing amount of [\$____] minus [\$____] in fees or charges that will be withheld.”
APR Used for closed-end transactions and factoring	“This is your total cost expressed as an annualized rate that you can compare with the APRs of other financing options.”
Estimated APR When used for sales-based transactions, Historical Method	“This is an estimate of your total cost expressed as an annualized rate that you can compare with the APRs of other financing options.”
Estimated APR When used for sales-based transactions, Opt-In Method	“This is an estimate of your total cost expressed as an annualized rate you can compare with the APRs of other financing options. This estimate is based on the projections we used to set the terms of this offer, projecting your sales volume will average [\$____] per month.”
Estimated APR When used for open-end credit plans	“This is an estimate of your total cost expressed as an annualized rate you can compare with the APRs of other financing options. This estimate is based on drawing all available funds and making minimum payments.”
Estimated APR When used for invoice financing master financing agreements	“This is an estimate of your total cost expressed as an annualized rate you can compare with the APRs of other financing options. This estimate is based on using all available funds.”

Payment Amount and Frequency	Payment amount and frequency should both be disclosed. For example, “Daily Payment of X” or “Weekly Payment of Y” or “Daily Payment of Z% your sales through credit cards.”
Monthly Payment Used for closed-end transactions with monthly payments	
Projected Monthly Payment Used for open-end credit plans or sales-based transactions with monthly payments	
Projected Payments per Month Used for open-end credit plans or sales-based transactions with payment frequency other than monthly	“We estimate your [daily/weekday/weekly/biweekly] payments will total about [\$____] per month.”
Term	
Estimated Term Used for sales-based transactions	
Finance Charge, or Estimated Finance Charge in the case of open-end credit plans or financing with master financing agreements	The Finance Charge should be accompanied by a break down of the interest, fees, or other charges it represents. For example: \$3,464.51 in interest \$500 in account management fees (\$20 per month) \$200 draw fee (1% of draw amount) <u>+ \$600 origination fee</u> = \$5,909.51

<p>Prepayment Policies</p> <p>Notes: Where [Yes] / [No] appears, the provider would circle either “Yes” or “No” and cross out the other word.</p> <p>If “No” is selected, the sentence following “If Yes” would not be included.</p> <p>If the term is estimated for the product, include the word “Estimated” in the brackets. If the term is fixed, do not.</p>	<p>“[Yes] / [No] - If you pay off the financing before the [Estimated] Term, will you be required to pay finance charges other than interest since your last payment?”</p> <p>[If Yes] “The finance charge due at payoff could be as high as [\$ ____].”</p> <p>“[Yes] / [No] - Does paying off ahead of the [Estimated] Term result in any additional fees or charges, not already included in the Finance Charge?”</p> <p>[If Yes] “The additional fees could be as high as [\$ ____].”</p>
---	---

With respect to other language that may appear in a disclosure, no included language should denigrate the usefulness of APR. This has been a concern about some disclosures in the market. For example, it would not be appropriate for a provider to include language describing APR as best suited for comparing products of similar terms. In fact, the purpose of annualizing a rate is to make comparisons of cost across products of different terms. Inaccurate descriptions of APR should be prohibited.

XVII. Disclosure Formatting

Disclosures formatting should reflect the “4 Cs” of transparency. Disclosures should be Clear, Conspicuous, Complete, and Comparable across the range of financing options that may be considered.

Timing - These disclosure rules should apply any time terms are summarized for the borrower for a specific offer, including by a broker. If a broker “extend[s] a specific offer of commercial financing” on behalf of a lender, the broker would also be considered a provider under SB 1235, and so would also be subject to the same disclosure standards.⁶⁰ These disclosure standards should include offers that are presented as “prequalified” or “pre-selected” if specific terms are described.

Formatting - There is a risk that some providers may seek to dilute these disclosures by including many other, redundant or completing disclosure terms, or burying the required disclosures among other content. We suggest that the six disclosure elements considered in SB 1235, along with the explanatory text describing each element, be required to appear together on a single page.

These six elements should be required to appear in the following order: Amount of Funds Provided, APR or Estimated APR, Payment information, Term or Estimated Term, Finance Charge, and Prepayment.

Font Sizing - The numbers for Total Amount of Funds, APR or Estimated APR, the payment amount summary (Monthly Payment, Total Payments Per Month, or Projected Payments Per Month), Term or Estimated Term, and Financing Charge should appear in clear and legible font that is different than other content on the page, excepting headlines.⁶¹ The explanatory text describing each of these, and the prepayment, should be smaller than these numbers, though legible and larger than other content on the page not required by SB 1235.

Online Disclosure Considerations - The consent signature to acknowledge the disclosure should not be accessible until all required elements of the disclosure have been seen. For example, if scrolling is required to view all required elements of the disclosure, the signature should be below these disclosure elements.

⁶⁰ Cal. Civ. Code § 22800-22805.

http://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=FIN&division=9.5.&title=&part=&chapter=&article=

⁶¹ Headlines should not include other financing terms to circumvent disclosure standards

Specific Considerations for Term and Estimated Term - For ease of comparability, term should be disclosed in units of months if less than 1 year, and months or years if greater than one year. This is suggested because it may be cumbersome for small businesses to compare terms of 218 days to 0.61 years to 7.27 months, though these are all the same term.⁶²

⁶² Assuming 30 day months, as defined in TILA Appendix K (b)(5) CFPB, Appendix J to Part 1026 — Annual Percentage Rate Computations for Closed-End Credit Transactions,” n.d. “<https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/J/>.”

XVIII. Suggestion for Calculation Aids

Publishing a calculator or calculation aids would be an effective way for the Department to encourage consistent application of its disclosure calculation rules. This would bring certainty to providers and more reliable disclosures for small businesses, and potentially reduce the support burden on the Department as well by providing clear guidance and reducing instances of regulatory violations.

There are a number of examples the Department can look to of regulators referencing calculation support tools for disclosure calculations. For example, Regulation Z itself refers providers to the “Regulation Z Annual Percentage Rate Tables” produced by the CFPB:

“(b)*Computation tools.*

(1) The Regulation Z Annual Percentage Rate Tables produced by the Bureau may be used to determine the annual percentage rate, and any rate determined from those tables in accordance with the accompanying instructions complies with the requirements of this section. Volume I of the tables applies to single advance transactions involving up to 480 monthly payments or 104 weekly payments. It may be used for regular transactions and for transactions with any of the following irregularities: an irregular first period, an irregular first payment, and an irregular final payment. Volume II of the tables applies to transactions involving multiple advances and any type of payment or period irregularity.”⁶³

Similarly, the OCC has published APR calculation software called the Annual Percentage Rate Calculation Program for Windows (APRWIN).⁶⁴ Regulation Z explicitly endorses the use of calculator tools like this. “Creditors may use any other computation tool in determining the annual percentage rate if the rate so determined equals the rate determined in accordance with Appendix J to this part, within the degree of accuracy set forth in paragraph (a) of this section.”⁶⁵ This explicit regulatory endorsement would apply to the OCC’s APRWIN, as well as Microsoft Excel, Google Sheets, or the online calculators produced by Nav provided they produce an appropriately accurate APR. To develop calculation aids, the Department could draw on any of these resources.

If the Department does not wish to produce its own calculators, an alternative approach could be to publish formulas that can be used in software programs like Microsoft Excel and Google

⁶³ 12 C.F.R. § 1026.22(b)(1).

<https://www.govinfo.gov/app/details/CFR-2012-title12-vol8/CFR-2012-title12-vol8-sec1026-22/context>.

⁶⁴ Office of the Comptroller of the Currency, Annual Percentage Rate Calculation Program for Windows (APRWIN),” n.d. <https://www.occ.treas.gov/tools-forms/tools/compliance-bsa/aprwin-software.html>.

⁶⁵ 12 C.F.R. § 1026.22(b)(2).

<https://www.govinfo.gov/app/details/CFR-2016-title12-vol9/CFR-2016-title12-vol9-sec1026-22/context>.

Sheets to perform the required calculations.⁶⁶ The following calculations could be helpful to providers:

Calculating APR or Estimated APR for products with payments of the same amount.

This formula could be used in Microsoft Excel or Google Sheets for:

- Most closed-end transactions,
- Sales-based transactions if Projected Sales Volume is projected to remain at a flat rate,
- Open-end credit plans if the minimum payments used in calculating Estimated APR are of the same amount, and
- Factoring transactions, in which there is effectively only one payment.

APR or Estimated APR = RATE ((number of payments), (payment amount as a negative number), (amount of funds provided)) x (number of payments periods that occur in a year, to annualize the rate)

Number of payment periods used to annualize a rate

- If payments occur daily, the number of payment periods in a year would be 365 or 360.
- If payments occur on weekdays only, the number of payment periods in a year would be 260.71 or 257.14. This is 365 or 360 days per year, respectively, divided by 7 days per week, multiplied by 5 weekdays per week.
- If payments occur weekly, the number of payment periods in a year is 52.14 or 51.43 This is 365 and 360 days, respectively, divided by 7 days per week. We suggest that 52 also be permissible.
- If payments occur monthly, the number of payment periods in a year would be 12. This represents an assumption of equal months of 30 days.

Fees paid at origination are excluded from the amount of funds provided. Fees that occur regularly, in the same amount each payment, should be included within the payment amount. If post-origination fees occur at irregular periods or amounts after origination, then the formulas below for irregular payment amount should be used instead.

Here is an example of an APR calculated using the RATE formula:

⁶⁶ The Department could specify which editions of the software perform these calculations to the Department's satisfaction, such as "Microsoft Excel 365 and earlier editions."

Figure 31 - APR calculated using the RATE formula. This considers a merchant cash advance of \$100,000, with projected monthly payments of \$17,156.14 over 6 months.

	A	B	C
1	Loan Amount	100,000	
2	Estimated APR	10.00%	=RATE(B3,B4,B1)*12
3	Term (months)	6	
4	Payment	-\$17,156.14	

Calculating APR or Estimated APR for products with payments of different amounts

This formula could be used in Microsoft Excel or Google Sheets for:

- Closed-end transactions with different payments amounts, such as a odd first or last payment, or financing structured with larger payments made earlier in the term,
- Sales-based transactions if Projected Sales Volume is projected to rise or fall within the Opt-In Program
- Open-end credit plans if the minimum payments used in calculating Estimated APR are of different amounts

APR or Estimated APR = IRR (select series of cells beginning with the amount of funds provided as a positive number, followed by the payment amounts for each period as a negative number, in order) x (number of payments periods that occur in a year, to annualize the rate)

The time period between each cell selected in the IRR formula must represent an equal period of time. For example, if the payment occurs on weekdays only, weekend days where no payment takes place must be included as blank cells. This way, the time between each cell reflects the equal period of time of one day.

The number of payment periods used to annualize the rate is the same as discussed for the RATE formula above.

Fees that are to be included in the APR or Estimated APR and take place after origination should be included within a payment period. For example, if a monthly payment amount is \$1,000, and a fee is also charged that month for \$200, the cell should reflect a total amount of \$1,200.

In the example in Figure 32 below, the the IRR formula is used to calculate an APR for same MCA as considered in Figure 31:

Figure 32 - Estimated APR calculated using IRR formula for the same MCA as in Figure 31

	A	B	C	D	E	F	G	H	
1	Estimated APR	10.00%	<-- The IRR formula here is simply: =IRR(B4:H4)*12						
2									
3	Month	1/1/2018	2/1/2018	3/1/2018	4/1/2018	5/1/2018	6/1/2018	7/1/2018	
4	Payment	100,000	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14	-\$17,156.14	

The IRR formula works as well for different payment amounts. This example considers a business with Projected Sales Volume expected to rise over time, with a fee assessed in the third month, and no payment made in the fifth month:

Figure 33 - Estimated APR calculated for MCA projecting varying payment amounts

	A	B	C	D	E	F	G	H	
13	Estimated APR	11.76%	<-- The IRR formula here is simply: =IRR(B16:H16)*12						
14									
15	Month	1/1/2018	2/1/2018	3/1/2018	4/1/2018	5/1/2018	6/1/2018	7/1/2018	
16	Payment	100,000	-\$15,000.00	-\$18,000.00	-\$20,500.00	-\$23,000.00	\$0.00	-\$27,000.00	

XIX. Complaint Reporting

In order to ensure that these disclosure requirements are implemented consistently and accurately across the industry, we encourage the Department to create an online portal or similar mechanism for submitting and publicly monitoring complaints by small business owners. Building on the best practices from the CFPB's consumer complaint database, this portal would serve several important functions. First, it would streamline the process by which small business owners formally complain about misleading or incorrect disclosures, signaling to small business owners that the Department actively seeks their input and takes seriously their complaints.

Secondly, by allowing business owners, community groups and others to easily and regularly monitor the content and frequency of the complaints, it enables them to better understand and act on patterns of misbehavior. This is particularly important given that while SB 1235 requires disclosure from a wide range of small business financing companies, it does not require unlicensed parties to obtain a license or be otherwise regulated by the Department. Therefore, an online complaint database would facilitate small businesses and their advocates to more effectively pursue the private right of action granted through SB 1235, thereby complementing the enforcement activities of the Department. The small business finance sector is closely watching how SB 1235 is implemented and enforced in California, so we encourage the Department to invest the needed resources upfront to allow small business owners to support enforcement. At a bare minimum, we believe the Department should provide a quarterly public report as to the number and type of complaints by provider.

The Department of Business Oversight has a unique opportunity to lay a path for responsible innovation that fosters healthy competition, creates a better small business lending market, and enables small businesses to flourish. We welcome further discussion of these recommendations, and can be reached at info@borrowersbillofrights.org. Thank you for this opportunity to comment.

Sincerely,

The Responsible Business Lending Coalition

Members of the Responsible Business Lending Coalition include:

Accion

Aspen Institute

Community Investment Management

Funding Circle

Lending Club

Opportunity Fund

Small Business Majority

Appendices

- A. Draft proposed rules language for the Department to consider
- B. Letter National Consumer Law Center letter on Annual Percentage Rate (APR) and Annual Cost of Capital (ACC), dated July 30th, 2018
- C. Excerpt from Conference of State Bank Supervisors' Fintech Industry Advisory Panel, including call for disclosures with APR.
- D. Examples of commercial financing providers who have agreed to disclose APR

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

Preliminary Note: The suggested draft regulations outlined below are intended to encapsulate portions of the response by the Responsible Business Lending Coalition (RBLC) to DBO’s Invitation for Comments on Proposed Rulemaking (PRO 01-18), but they are not intended to be all-inclusive. A number of other key elements that are discussed at length in the RBLC comment letter are not covered in the suggested language below, but are nevertheless considered by RBLC to be essential elements of the complete rulemaking. Examples include disclosure formatting, disclosure elements including payment amount and prepayment, explanatory language, prohibitions on misleading forms of rate, and calculation aids. RBLC appreciates DBO’s commitment to further engage with stakeholders prior to beginning formal rulemaking pursuant to the Administrative Procedure Act.

California Code of Regulations
Title 10. Investments
Chapter 3. Commissioner of Business Oversight, Division of Corporations

Subchapter 15.¹ Commercial Financing Disclosures

§ 2100. Definitions

The following definitions govern the construction of this Subchapter:

- (a) “Accounts receivables purchase transaction” shall have the same meaning as that term is defined in subdivision (b) of Section 22800 of the Financial Code.
- (b) “Amount of funds provided” is the total contractual amount of the financing provided by a provider to a recipient, including any fees or charges that are withheld by the provider before disbursement to the recipient.
- (c) “Annual Percentage Rate” is the rate that shall be calculated pursuant to **Section 2115**, taking into account the amount of funds provided, the amounts charged in interest, fees, and other charges, and the term over which payments take place.
- (d) “Asset-based lending transaction” shall have the same meaning as that term is defined in subdivision (c) of Section 22800 of the Financial Code
- (e) “Closed-end transaction” means a transaction in which credit is extended only once over a specific period. A closed-end transaction is repaid in regular payments of specified amount, over a fixed period of time. A closed-end transaction includes financing that is provided to a recipient in the form of a cash advance or a term loan.

¹ Subchapter 15 is next in order in Chapter 3, 10 Cal. Code Regs.

Appendix A

Proposed Regulatory Provisions on Selected Issues

File No: PRO 01-18

Submitted by the Responsible Business Lending Coalition

(f) “Commercial open-end credit plan” shall have the same meaning as that term is defined in subdivision (f) of Section 22800 of the Financial Code

(g) “Commercial financing” shall have the same meaning as that term is defined in subdivision (d) of Section 22800 of the Financial Code.

(h) “Factoring” shall have the same meaning as that term is defined in subdivision (i) of Section 22800 of the Financial Code.

(i) “Provider” shall have the same meaning as that term is defined in subdivision (m) of Section 22800 of the Financial Code

(j) “Recipient” shall have the same meaning as that term is defined in subdivision (n) of Section 22800 of the Financial Code.

(k) “Retrospective annualized rate” is the actual annualized rate, determined after the specific financing contract has been fully repaid to the provider, when the dates and amounts of payments and fees are known. It may be calculated using the formula:

$$0 = CF_0 + \frac{CF_1}{(1 + IRR)} + \frac{CF_2}{(1 + IRR)^2} + \frac{CF_3}{(1 + IRR)^3} + \dots + \frac{CF_n}{(1 + IRR)^n}$$

Or

$$0 = NPV = \sum_{n=0}^N \frac{CF_n}{(1 + IRR)^n}$$

Where:

CF_0 = Initial Investment / Outlay

$CF_1, CF_2, CF_3 \dots CF_n$ = Cash flows

n = Each Period

N = Holding Period

NPV = Net Present Value

IRR = Internal Rate of Return

Alternatively, a retrospective annual percentage rate may be computed using the formula “IRR” in publicly available software programs, such as Microsoft® Excel and Google Sheets®.

(l) “Sales-based financing” is an accounts receivable purchase transaction or asset-based lending transaction that is repaid by the recipient to the provider as a percentage of sales, in which the payment amount increases and decreases according to the volume of sales made by the recipient. Sales-based financing may include advances, loans, or other forms of financing.

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

(m) “Total repayment amount” means the sum of all scheduled or projected payments of funds that the recipient agrees to pay to the provider.

§ 2110. Annualized Rate Disclosure

Any provider who extends a specific offer of commercial financing to a recipient shall, at the time of extending the specific commercial financing, disclose to the recipient the annual percentage rate.

§ 2115. Calculation of Annual Percentage Rate

(a) The annual percentage rate is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of value received by the recipient to the amount and timing of payments made to the provider. For purposes of this Subchapter, the annual percentage rate shall be determined in accordance with the actuarial method set forth in Appendix J, 12 C.F.R. Part 1026, as it may be amended, and which is incorporated herein by this reference.

(b) The actuarial method described in subdivision (a) specifies that, when no payment is made, or when the payment is insufficient to pay the accumulated finance charge, the actuarial method requires that the unpaid finance charge be added to the amount financed and thereby capitalized. Interest is computed on interest since in succeeding periods the interest rate is applied to the unpaid balance including the unpaid finance charge.

(c) The annual percentage rate shall be considered accurate if it is not more than 1/8 of 1 percentage point above or below the annual percentage rate determined in accordance with paragraph (a) of this section.

(d) (1) The annual percentage rate shall be the nominal annual rate determined by multiplying the unit-period rate by the number of unit-periods in a year.

(2) The term of the transaction begins on the date of its consummation, except that if the finance charge or any portion of it is earned beginning on a later date, the term begins on the later date. The term ends on the date the last payment is due, except that if an advance is scheduled after that date, the term ends on the later date. For computation purposes, the length of the term shall be equal to the time interval between any point in time on the beginning date to the same point in time on the ending date.

(e) The annual percentage rate shall include any fees or charges payable directly or indirectly by the recipient and imposed directly or indirectly by the provider incident to or as a condition of

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

the extension of credit or commercial financing, including application fees, overdraft fees, and additional fees for credit insurance and related charges.²

(f) If, as a condition of refinancing or renewing a provider's existing advance or loan to a recipient, the provider requires the recipient to pay off or pay down the balance of the existing loan or advance, including any unpaid or un-accrued interest or fees, the annual percentage rate shall be considered inaccurate and misleading if it does not reflect the annualized cost of previous loans or advances which were required to be paid off or paid down within the current sequence of financing. The current sequence of financing includes the new transaction being considered as well as all capital provided by the provider to the recipient, and all payments and fees paid historically by the recipient to the provider, until a point at which the recipient held no financing with the provider that was repaid as a condition of subsequent financing from the provider.³

§ 2120. Closed-End Transactions

A provider shall disclose to a recipient the annual percentage rate for all term loans and closed-end transactions. The annual percentage rate shall be disclosed in accordance with Sections 2110 and 2115.

§ 2125. Commercial Open-End Credit Plans

A provider shall disclose to a recipient the annual percentage rate for all commercial open-end credit transactions, plans or lines of credit. The annual percentage rate shall be disclosed in accordance with Sections 2110 and 2115. In addition to the provisions of Section 2115, relating to the calculation of annual percentage rate, a provider shall also assume that the financing is drawn once immediately to the maximum amount financed, with repayment based on the minimum payment amount.

§ 2130. Accounts Receivable Purchase Transactions; Merchant Cash Advances

(a) A provider shall disclose to a recipient the annual percentage rate for all accounts receivable purchase transactions. The annual percentage rate shall be disclosed in accordance with Sections 2110 and 2115.

² See, 32 CFR 232.4(c)(1). See also, Federal Reserve Military Lending Act Examination Procedures, at pages 24-25, located at https://www.federalreserve.gov/supervisionreg/caletters/Attachment_CA_Letter_16-6_MLA_Exam_Procedures.pdf

³ This subdivision is intended to provide transparency by accurately reflecting APR impact of a common financial industry practice known as "double dipping," which occurs when a "recipient" refinances or renews funding with its current funding "provider," and the proceeds from the new loan or advance (including any unpaid and un-accrued interest or fees) is used to pay off the balance from the previous contract.

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

(b) With respect to accounts receivable purchase transactions, the estimated annual percentage rate shall be calculated based on the daily, weekly, or monthly delivery of receivables from the business to the financier that is assumed as part of the financing offer. This shall be labeled “annual percentage rate” or “estimated annual percentage rate.”⁴

§ 2135. Accounts Receivable Purchase Transactions; Historical Method for Calculating Estimated Annual Percentage Rate

(a) The estimated sales projection for accounts receivable purchase transactions shall be calculated as the recipient’s historical average sales volume associated with respect to a particular payment channel or mechanism over the months preceding the financing offer.

(b) A provider shall fix the number of months considered to determine the recipient’s average historical sales, provided that the period of historical data used by the provider shall not be less than one (1) month, shall not exceed twelve (12) months, shall be utilized by the provider to determine the projected sales volume, and shall be applied in all financial products offered by the provider.

(c) Where accounts receivable purchase transaction contracts include provisions establishing a penalty sales volume, below which the recipient or financing customer either incurs a penalty, must pay a higher rate, or must make a minimum payment, that amount shall be utilized by the provider as the estimated sales projection if the penalty sales volume is higher than the historical average sales projection.

(d) If payments on an accounts receivable purchase transaction product are withdrawn on a daily basis, the projected sales volume shall also be measured on a daily basis, and shall be used in daily units for purposes of calculating estimates. If such payments are withdrawn only on weekdays, then historical weekday sales shall be used to establish the projected sales volume.

(e) The amount of payments for a given period of time shall be calculated by multiplying the split rate, or the percentage of sales that go toward repayment, by the estimated sales projection, unless the product contract or offer specifies a minimum or penalty payment amount that is higher than the estimated payment amount as calculated above, in which that amount would be used.⁵

(f) For purposes of this Section, the estimated term is the period of time required for the projected payment amounts to equal the total repayment amount. If the product contract or offer includes a maximum term, or penalty term, after which the borrower incurs fees or other adverse changes to the contract, then this term shall be regarded as the estimated term.

⁴ See, e.g., proposed Fin. Code § 22802 (b)(4), in SB 1235 (Glazer), as amended in Senate April 9, 2018.

⁵ See, Regulation Z, Section 1026.4(a)

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

(g) Estimated annual percentage rate shall be determined in accordance with Section 2115.

§ 2140. Accounts Receivable Purchase Transactions; Opt-In Method for Calculating Estimated Annual Percentage Rate

(a) In accounts receivable purchase transactions, a provider may elect to employ a projected sales volume that the provider utilizes internally in its normal course of business to underwrite the commercial financing. If a provider elects this opt-in method for calculating estimated annual percentage rate, it shall disclose to the recipient that the estimated annual percentage rate relies on the provider's own assumptions used to underwrite the financing, and shall report to the Department on the accuracy of its disclosures.

(b) (1) Prior to employing the opt-in method specified in this Section for calculating estimated annualized rate, a provider shall apply to the Department for authorization to employ the opt-in method. The Department shall specify the form and content of the application.

(2) Upon authorization by the Department to employ the opt-in method for calculating estimated annualized rate, the provider shall sign an agreement with the Department, in which the provider shall agree to report the following information to the Department on a periodic⁶ basis:

(A) The amount financed.

(B) The projected total payments per month.

(C) The average monthly payments actually made by the recipient upon repayment.

(D) The estimated annualized rate initially disclosed to the recipient.

(E) The retrospective annual percentage rate that is calculated upon repayment by the recipient.

(3) Information provided to the Department by a provider pursuant to this Section shall be considered confidential and not subject to disclosure by the Department pursuant to the Public Records Act, (Government Code Section 6250 et seq.).

(c) In the event a provider fails to adhere to the tolerances for accuracy of portfolio average estimated annual percentage rate disclosed, as compared to portfolio average retrospective annual percentage rate, the Department may require a provider to submit additional information

⁶ RBLC recommends quarterly or semi-annually

Appendix A
Proposed Regulatory Provisions on Selected Issues
File No: PRO 01-18
Submitted by the Responsible Business Lending Coalition

concerning the subject transactions or may revoke the provider's authority to employ the opt-in method for calculating annualized rate.

§ 2145. Factoring

A provider shall disclose to a recipient the annual percentage rate for all factoring transactions. The annual percentage rate shall be disclosed in accordance with Sections 2110 and 2115. A provider shall utilize the term established by the payment due date of the receivables, or estimate the term for a factoring transaction by reference to its historical data concerning customer payment rates over a period not to exceed the previous twelve (12) months.

§ 2150. Enforcement

(a) Any provider licensed under the California Financing Law [Division 9 (commencing with Section 22000) of the Financial Code] shall be subject to examination and enforcement by the Commissioner.

(b) It is unfair competition pursuant to Section 17200 of the Business and Professions Code for any provider to systematically and in bad faith violate this Subchapter or Division 9.5 (commencing with Section 22800) of the Financial Code.

o0o



BOSTON HEADQUARTERS
7 Winthrop Square, Boston, MA 02110-1245
Phone: 617-542-8010 • Fax: 617-542-8028

WASHINGTON OFFICE
1001 Connecticut Avenue NW, Suite 510, Washington, DC 20036
Phone: 202-452-6252 • Fax: 202-463-9462

www.nclc.org

July 30, 2018

Louis Caditz-Peck
Director, Public Policy and Regulatory
LendingClub
71 Stevenson St. #1000
San Francisco, CA 94105

Heidi Pickman
Associate Director
CAMEO
1 Hallidie Plaza, Suite 715
San Francisco, CA 94102

Dear Mr. Caditz-Peck and Ms. Pickman:

You have asked for my opinion about the use of a newly-designed metric, the “Annualized Cost of Capital” or “ACC,” to disclose the cost of extensions of credit to small businesses. I have researched and written on consumer lending issues for over thirty years, and am one of the authors of the National Consumer Law Center’s (NCLC) *Consumer Credit Regulation* treatise (2d ed. 2015) and a contributing author to its *Truth in Lending* treatise (9th ed. 2015).

My opinion is that this metric would be not only uninformative but affirmatively misleading. It would sow confusion and make accurate comparisons to other sources of credit impossible. Authorizing this misguided metric would harm both small businesses and consumers.

The APR is the keystone of the disclosure system created by the federal Truth in Lending for consumer credit. It is designed to capture the true cost of credit, taking into account both the interest rate and flat fees. It enables a borrower to make an apples-to-apples comparison of the cost of two loans *even if those loans are for different amounts, have a different mix of interest and flat fees, are repayable over different lengths of time, or have irregularities in the amounts or due dates of payments.*

The Truth in Lending APR was mandated *precisely because of the inadequacies of metrics like the ACC.* Prior to the Truth in Lending Act, states expressed the limits on interest rates through a welter of confusing and misleading measures. One common measure was the “add-on” interest rate: a measure of the cost of credit much like the ACC that did not take the declining balance into account (*i.e.*, the fact that, as the loan is paid off, interest accrues on a smaller balance).

The analysis of S.B. 1235 prepared for the Senate Committee on Banking and Financial Institutions for its April 18 hearing expresses concern that the Truth in Lending Act APR disclosure does not take into account the possibility of a weekly (rather than monthly) payment schedule or accommodate varying payment amounts. In fact, the Truth in Lending Act explicitly *requires* the APR disclosure to take weekly payment schedules and varying payment amounts into account. Appendix J to TILA's Regulation Z gives specific instructions for making these calculations. The regulation for computing the APR, 12 C.F.R. § 1026.22(b)(1) provides:

(b) Computation tools.

(1) The Regulation Z Annual Percentage Rate Tables produced by the Bureau may be used to determine the annual percentage rate, and any rate determined from those tables in accordance with the accompanying instructions complies with the requirements of this section.

Volume I of the tables applies to single advance transactions involving up to 480 monthly payments or 104 *weekly* payments. It may be used for *regular transactions and for transactions with any of the following irregularities: an irregular first period, an irregular first payment, and an irregular final payment.* Volume II of the tables applies to transactions involving multiple advances and *any type of payment or period irregularity.*

(Emphasis added.)

When the Truth in Lending Act was first enacted, computerized APR calculation tools were not widely available. This was the impetus for the Federal Reserve Board's creation of the APR tables. Anyone who knows how to multiply and divide can use these tables. Not even a hand-held calculator is necessary.

The widespread availability of computerized calculation tools has made APR calculations even easier today. Many APR calculators are available free on the internet, including one provided by the federal Office of the Comptroller of the Currency, the regulator of national banks: <https://www.occ.treas.gov/tools-forms/tools/compliance-bsa/aprwin-software.html>. The TILA regulations explicitly endorse the use of these APR calculators:

(2) Creditors may use any other computation tool in determining the annual percentage rate if the rate so determined equals the rate determined in accordance with appendix J to this part, within the degree of accuracy set forth in paragraph (a) of this section.

12 C.F.R. § 1026.22(b)(2).

The analysis prepared for the committee also expresses concern about certain types of business financing in which the repayment period is not known with certainty in advance. The APR can be easily accommodated to this type of lending by estimating the repayment period. Responsible business lenders already provide an APR using such an estimate – see, for example, <https://www.americanmerchantbrokers.com/merchant-cash-advance-calculator.html>. This approach would simply codify the existing best practices of the small business lending industry. The Truth in Lending regulations already endorse the use of estimates when the information necessary for a completely accurate disclosure is unknown to the creditor:

Basis of disclosures and use of estimates. Disclosures shall reflect the terms of the legal obligation between the parties. If any information necessary for accurate disclosure is unknown to the creditor, it shall make the disclosure based on the best information reasonably available and shall state clearly that the disclosure is an estimate.

12 C.F.R. § 1026.5(c).

Allowing business lenders to disseminate a measure of the cost of credit different from the APR would be harmful both to small businesses and to consumers. Owners of small businesses would be unable to compare the cost of a business loan to the cost of a personal loan or a credit card. Many small businesses finance their businesses using personal credit lines.

Moreover, because the ACC fails to take the declining balance into account, it is a profoundly inaccurate measure of the cost of credit. Dissemination of this inaccurate metric would inevitably reach consumers through advertisements and media, so would cause confusion in the consumer credit market too.

As mentioned above, I am an attorney and have researched and written on consumer lending issues for over thirty years. I am one of the authors of the National Consumer Law Center's *Consumer Credit Regulation* treatise (2d ed. 2015) and a contributing author to its *Truth in Lending* treatise (9th ed. 2015). I am also the primary author of two recent reports on consumer installment lending: *Predatory Installment Lending in 2017: States Battle to Restrain High-Cost Loans* (Aug. 2017), available at <https://www.nclc.org/images/pdf/pr-reports/installment-loans/report-installment-loans.pdf>, and *Installment Loans: Will States Protect Borrowers from a New Wave of Predatory Lending?* (July 2015), available at <https://www.nclc.org/issues/installment-loans.html>. For these reports I determined the maximum APRs allowed by the consumer credit laws of each of the fifty states for four sample extensions of credit. I was a member of the Federal Reserve Board's Consumer Advisory Council from 2005 to 2007, where the issues I addressed included disclosures in consumer credit transactions. I have written substantial portions of detailed technical comments regarding disclosure of the cost of credit and have submitted affidavits regarding annual percentage rate (APR) calculations as an expert witness.

Please let me know if I can answer any questions.

Sincerely yours,


Carolyn L. Carter
Deputy Director

Appendix C - Excerpt from Conference of State Bank Supervisors' Fintech Industry Advisory Panel, including call for disclosures with APR

Recommended Disclosure Elements

1. Financing Amount
2. Disbursement Amount, after any fees deducted or withheld at disbursement
3. Cost Comparison Metrics:^[13]
 - a. Total Cost of Capital^[14]
 - b. APR or Estimated APR^[15]
4. Term or Estimated Term^[16]
5. Periodic Payment Amount:
 - a. If payments are a fixed amount, provide the payment amount and frequency (e.g., daily, weekly, monthly), and the average monthly payment amount if payment frequency is other than monthly
 - b. If payments are a variable amount, provide a description of the method used to calculate payment amounts and frequency of payments, and the estimated monthly payment amount^[17]
6. Description of all other potential fees and charges that can be avoided by the borrower (e.g., draw fees, late payment fees, returned payment fees)
7. Prepayment Charges, or a description of any fees, expenses or charges due when financing is paid in full
8. Collateral Requirements, if any

Appendix D - Examples of commercial financing providers who have agreed to disclose APR

Small Business Borrowers' Bill of Rights Signatories and Endorsers:



Innovative Lending Platform Association Members:

