SMALL BUSINESS MAJORITY

STATEMENT FOR THE RECORD

BEFORE THE MARYLAND SENATE FINANCE COMMITTEE ON

SB 0496 "CONSUMER CREDIT- COMMERCIAL FINANCING TRANSACTIONS" BILL

FEBRUARY 15, 2023

AWESTA SARKASH

PUBLIC POLICY DIRECTOR, SMALL BUSINESS MAJORITY

Thank you Chairwoman Griffith, Vice Chairwoman Klausmeier, and members of the committee.

My name is Awesta Sarkash and I am the Public Policy Director for Small Business Majority, a national small business organization that empowers America's diverse entrepreneurs to build a thriving and equitable economy. I also serve on the Executive Committee of the Responsible Business Lending Coalition (RBLC), a network of for-profit and non-profit lenders, investors and small business advocates, that organized in 2015 around a shared commitment to promoting innovation in small business lending and growing concerns about the rise of deceptive and irresponsible small business financing practices. As the only cross-sector collaboration, the RBLC is uniquely positioned to promote responsible practices in small business financing.

Thank you for the opportunity to discuss SB 0496, as introduced by Senator Kramer, which would enact critical protections for small business borrowers in Maryland that are falling prey to predatory lending practices.

There are few protections provided to small business owners seeking financing because the federal Truth-in-Lending Act does not apply to most commercial financing. This legislation, modeled after successful Small Business Truth in Lending laws enacted in California and New York, would provide commonsense protections for small business borrowers in Maryland. The bill is applicable to financing products below $2.5 million because smaller, Main Street businesses are the ones being misled by the lack of transparency today. This legislation provides transparency about the lending product, tells the online lender how to calculate APR and what to disclose to the borrower.

The original rationale for not extending federal truth-in-lending or disclosure protections to commercial loan transactions was based on the belief that businesses had much greater financial expertise at their disposal—they had comptrollers or chief financial officers on staff, or CPAs who could provide financial advice when they sought financing. This is certainly true for some businesses, but not for most small businesses. A majority of small businesses in the U.S. are sole proprietors, not corporations. They operate home day care centers; cleaning and landscaping businesses; food trucks, catering firms and cafes; small retail shops; hair and nail salons. They do their finances using QuickBooks, often in the evenings or around their core working hours. They may or may not have a part-time bookkeeper or accountant to help them set up their books, or an accountant or tax prep firm that helps them file taxes.

This legislation is needed because small businesses in Maryland could unknowingly agree to higher cost loan terms because predatory lenders can legally offer opaque terms through deceptive practices. A common reality for small businesses is thinking you're paying one price for your loan, and instead realizing, sometimes too late, that your actual annual percentage rate or "APR," is in fact in the triple digits. Sometimes borrowers discover that there are additional costs associated with their loan that that they were not made aware of.

APR is the only metric that enables an individual to make apples-to-apples comparisons among financing products with different fees, interest, and term lengths over a common unit of time. As has been documented by research conducted by the Federal Reserve, small business owners applying for financing online may be receive offers that quote prices in very different ways. For example, they may be offered a five-year term loan with a 15% interest rate and $1,000 origination fee, a 12-month cash advance with a 4% fee rate (not an interest rate), and a credit card with a 24.9% APR.[1] For the typical small business owner, it is very difficult to analyze and compare the relative costs of these products, and to determine their potential effect on their cash flow. As a result, small businesses today are often overpaying for financing, sometimes with devastating results for the business.

In fact, Federal Reserve research indicated that minority-owned firms more frequently applied for "potentially higher-cost and less-transparent credit products," specifically merchant cash advance and factoring products. This practice reinforces existing access to capital disparities and diminishes entrepreneurship. Small businesses recognize the need for this type of protection, which is why 75% of small businesses support the type of legislation we're discussing today.

We must pass SB 0496 because APR is the only metric that enables an apples-to-apples comparison of products of different types, amounts and lengths. Despite what you might hear today, this bill will not outlaw any financing products or restrict access to capital in any way. Simply requiring price transparency for Maryland's small businesses is a benefit to the small business ecosystem.

You may also hear from companies that offer merchant cash advances that they can't estimate APRs and disclose them. That is incorrect. Some merchant cash advance providers already disclose APR. And as of December 8, all financing companies serving small businesses in California are disclosing APR and starting on August 1, 2023 providers in New York will be as well. We strongly encourage Maryland to follow suit and implement SB 0496. Maryland's small businesses are depending on it.

[1] Barbara Lipman and Ann Marie Wiersch, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019. https://www.federalreserve.gov/publications/files/what-small-businessborrowers-find-when-browsing-online-lender-websites.pdf

NY Financing law press release.pdf
Uploaded by: cailey locklair
Position: FAV

SUPERINTENDENT ADRIENNE A. HARRIS ADOPTS UPDATED REGULATION FOR DISCLOSURE REQUIREMENTS FOR COMMERCIAL FINANCING

Regulation Ensures Small Businesses Have Adequate Information to Make Informed Decisions about Financing Offers

Rule Implements New York State's Commercial Finance Disclosure Law

Superintendent of Financial Services Adrienne A. Harris announced today that the New York State Department of Financial Services has adopted a new regulation relating to disclosure requirements for commercial financing, pursuant to sections 801 to 811 of the New York Financial Services Law (the "Commercial Finance Disclosure Law" or "CFDL").

To address the lack of standardized disclosures in small business lending, the New York State legislature passed a law, codified at Article 8 of the New York Financial Services Law (the "Commercial Finance Disclosure Law" or "CFDL"), mandating standardized disclosures for commercial financings below a certain principal amount.

The CFDL requires certain providers of commercial financing in amounts of up to $2,500,000 to provide standardized disclosures to potential borrowers at the time financing offers are extended. These standardized disclosures will help businesses and individuals understand and compare the terms of different commercial financing offers. The regulation implements the CFDL and provides specific instructions to commercial financing providers on how to comply with the CFDL.

“Clear and easy-to-compare disclosures are paramount as entrepreneurs and small businesses evaluate financing,” **said Superintendent of Financial Services Adrienne A. Harris**. “The new regulation aims to improve fairness and transparency in the financing process, so that entrepreneurs and New York businesses can effectively evaluate and choose the best offer available to them.”

Senator Kevin Thomas said, “As the sponsor of this important legislation in the Senate, I am grateful for the work Superintendent Harris and the Department of Financial Services have done to ensure New Yorkers are protected with information that can lead to making the right decisions in growing their business. Our business owners are the fabric of this State’s economy, and we remain committed to doing all we can to enhance their opportunities. I believe that it begins with expanding the awareness and access to commercial financing.”

Assemblyman Kenneth Zebrowski said, “Small businesses are the lifeblood of our communities, and it is important that they have adequate information before taking out loans. These disclosure requirements will ensure business owners have that information from commercial lenders and are not taken advantage of. I thank Superintendent Harris for her leadership in promulgating these directives and look forward to continuing to work with the Department of Financial Services to protect our small businesses.”

The regulation provides specific instructions to commercial financing providers on how to comply with the CFDL. Among its provisions, the regulation:

- Provides detailed definitions for terms used in the CFDL, and in the regulation itself;
- Explains how providers should calculate the finance charge and annual percentage rate;
- Sets forth formatting requirements for disclosures required by the CFDL, both generally and specifically for the following types of financing:
- Sales-based financing;
- Closed-end financing;

- Open-end financing;
- Factoring transaction financing;
- Lease financing; and
- General asset-based financing;
- Describes how the CFDL's disclosure threshold of $2,500,000 is calculated;
- Details certain duties of financers and brokers involved in commercial financing; and
- Prescribes a process under which certain providers calculating estimated annual percentage rates will report data to the Superintendent relating to the actual retrospective annual percentage rates of completed transactions, in order to facilitate accurate estimates for future transactions.

The regulation appears as Part 600 of Title 23 of the Official Compilation of Codes, Rules and Regulations of the State of New York. A copy of the final regulation is available on the DFS website.

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SB0496 - SUP - GR23.pdf
Uploaded by: Drew Jabin
Position: FAV

MARYLAND BANKERS ASSOCIATION

SB 496 – Consumer Credit Commercial Financing Transactions

Committee: Senate Finance Committee

Date: February 15, 2023

Position: Support

The Maryland Bankers Association (MBA) **SUPPORTS** SB 496, which would establish a regulatory framework for businesses engaged in commercial financing transactions. This new framework would appropriately fall under the regulatory and enforcement authority of the Office of the Commissioner of Financial Regulation (OCFR).

While OCFR currently has the power to investigate financial transactions to determine any violations, SB 496 would positively impact Maryland small businesses by implementing consistent standards and transparency requirements for commercial lenders to ensure equity and accountability in lending.

Maryland banks are proud to work with thousands of Maryland businesses to offer extensive responsible commercial financing products and services and strongly support transparency for all small business financing

This bill is a smart step forward in protecting Maryland small businesses and accordingly, MBA urges a **FAVORABLE** report on SB 496.

The Maryland Bankers Association (MBA) represents FDIC-insured community, regional, and national banks, employing more than 30,000 Marylanders and holding more than $181 billion in deposits in over 1,000 branches across our State. The Maryland banking industry serves about 4 million customers across the State and provides an array of financial services including residential mortgage lending, business banking, estates and trust services, consumer banking, and more.

AOF Testimony MGA 02142023.pdf

Uploaded by: Joshua Miller

Position: FAV

TESTIMONY BEFORE THE MARYLAND GENERAL ASSEMBLY
SENATE FINANCE COMMITTEE

JOSHUA MILLER, VICE PRESIDENT, RESEARCH and Policy
ACCION OPPORTUNITY FUND

ON FEBRUARY 15, 2023

Accion Opportunity Fund Testimony

Hello, Members of the Maryland Senate Finance Committee. I am pleased to join you today to support Senator Kramer's bill regarding Consumer Credit Commercial Financing Transactions. My name is Joshua Miller, and I am the Vice President of Research and Policy at Accion Opportunity Fund (AOF)—a leading nonprofit lender providing capital, networks, and coaching to under-resourced and underbanked entrepreneurs nationwide. To date, we have dispersed over 25,400 loans totaling $773 million. Over 90% of our clients are women, people of color, or low-to-moderate income.
We are expanding our access to capital to small businesses in Maryland. We have deployed over $2 million to almost 100 entrepreneurs in this state, with the majority of that capital black-owned and women-owned small businesses.

As founding members of the Responsible Business Lending Coalition (RBLC), we support SB0496, introduced by Senator Kramer, which would extend the truth in lending protections to those small businesses we serve daily. All this bill does is tell small business owners the truth about how much it will cost them to access financing by requiring the APR to be disclosed.

Over 90 percent of black-owned small businesses are sole props and have trouble finding access to capital from traditional banks. In this vacuum, factoring and merchant cash advance companies have targeted them with loan terms that include concepts such as "simple interest rate," "factor rate," and "fee rate," which misleads the borrower into believing that this is an APR. We have that a "simple interest rate of 20%" may have an annual interest rate of 66%, depending on the term of the loan.[1] 1.15 factor rate is really hiding a 70 percent APR.

I would be remiss if I did not make this as straightforward as possible- These products are designed to take advantage of communities such as black small-owned businesses and people who have already been locked out of traditional financing. We did a report on this type of financing and found that the average APR was 94% getting as high as 350% APR. This is not just, and it hurts our small businesses, and I encourage you to pass this bill as soon as possible to protect our underserved entrepreneurs.

Louis CP Maryland MD Testimony Sen Kramer SB496.pd

Uploaded by: Louis Caditz-Peck

Position: FAV

February 14, 2023

Senate Finance Committee
11 Bladen St
Annapolis, Maryland 21401

Re: Testimony in STRONG SUPPORT of SB496

Honorable Members of the Senate Finance Committee,

Thank you for this opportunity to provide testimony. I am a Senior Fellow at the National Community Reinvestment Coalition, and former Sr. Director of Public Policy at LendingClub, one of the largest online lenders in the nation. I also support the Responsible Business Lending Coalition, the leading small business financial protection organization in the country, and the only coalition on this issue that includes both nonprofit AND industry leaders. The Responsible Business Lending Coalition led the first small business Truth in Lending laws in the US, in California and New York, and offers its strong support for this bill.

I launched LendingClub's small business lending program in 2014 to offer lower-cost, transparent loans to businesses often underserved by other banks. I soon saw that small businesses are now inundated with offers of capital—often from a narrow segment of financing companies that charge high APRs and do not disclose those rates to their customers, and who now generally comprise the opposition to this truth in lending bill.

This bill does not outlaw any products or restrict access to capital in any way. It simply requires price transparency, including the disclosure of the Annual Percentage Rate (APR).

There is a simply reason why small business groups, the greater part of industry, researchers and officials of the Federal Reserve, and civil rights groups all agree that APR is the standard for transparent disclosure. This is because APR is the only metric that enables apples-to-apples comparisons of products of different types, amounts, and lengths. Unlike any other approach, APR has also been vetted in over 50 years of the federal Truth in Lending Act.

You may hear opposition from companies offering merchant cash advances who say that they can't estimate APRs and disclose them. That is incorrect. Some merchant cash advance providers already do disclose APR across the country. All merchant cash advance providers are required to disclosure APRs by law in California and New York.

To calculate APR, whatever the form of financing, companies can simply use the same formula set out in the Truth in Lending Act. It's algebra: you plug in how much money you get, how much you pay, and when, and you get an APR.

For sales-based financing, they will need to plug in some estimates. These companies have the estimates they need already. Financing companies do not give away money with no expectation of when that money will come back to them. SB 496 also provides two methods to guide these estimations, in the same approach NY and CA took.

I found that that it is difficult to compete as the lower-cost lender when the competition doesn't transparently disclose how expensive they actually are. That is one reason this bill is needed. Without transparent price disclosure, competition cannot bring prices down.

Without APR, a prospective borrower could not quickly compare the cost of borrowing $10,000, for example, using a five-year term loan with a 15% interest rate and $1,000 origination fee, to a 12-month cash advance with a 4% fee rate, to a credit card with a 24.9% interest rate. Without APR, there's no basis for apples-to-apples price comparison.

Predatory lending is taking down small businesses in your districts. I spoke with Kara DePietro, CEO of a manufacturing company in Columbia. Her company produces materials for commercial interiors, including for Johns Hopkins University and the US Capitol.

Ms. Depietro is a savvy businesswoman—she was named Maryland Small Business Owner of the Year by the SBA. She told me that when she took a new round of financing, the contracts seemed clear. But they turned into a whack-a-mole of lies. A series of inter-related financing companies hooked her by sending her less than the agreed-on amount of money, and as she tried get the full amount, they pulled her through a goose chase of refinances, adding fees each time.

Her contract had focused on price of 10%, but this wasn't a real APR. Her lawyers later figured out that the APR was 200%. At the end of the day, this financing lost her hundreds of thousands of dollars of businesses, as her company spent 3 years in survival mode, fighting off these predatory lenders instead of growing and creating jobs in Maryland.

I urge you to advance this bill. Small businesses are depending on it. Thank you.

Louis Caditz-Peck

Maryland Letter of Support for SB 0496 to Senate F
Uploaded by: Mary Childs
Position: FAV

RESPONSIBLE BUSINESS LENDING COALITION

February 14, 2023

Maryland Senate Finance Committee
House Office Building
11 Bladen Street
Annapolis, Maryland 21401

RE: Support for SB 0496 (Consumer Credit Commercial Financing Transactions)

Dear Members of the Maryland Senate Finance Committee:

The Responsible Business Lending Coalition (RBLC) writes in support of SB 0496*, Consumer Credit Commercial Financing Transactions,* as introduced by Senator Ben Kramer. The bill aims to bring transparency to the small business lending marketplace through standardized disclosures, particularly disclosure of the annual percentage rate (APR). When small business owners are empowered with clear information about their financing options, they have the agency to choose the best product for their needs.

The undersigned organizations represent members of the RBLC, a leading cross-sector voice on small business financial protection. The coalition includes nonprofit and for-profit fintechs, community development financial institutions (CDFIs), investors, and small business advocates who all share a commitment to innovation in small business lending as well as serious concerns about the rise of irresponsible small business lending. Two of our member organizations, Small Business Majority (SBM) and Accion Opportunity Fund (AOF), will testify in support of this bill as it is considered through the Maryland Senate Finance Committee.

As introduced, SB 0496 would bring sunshine to the commercial financing marketplace by requiring all providers to disclose APR for all small business loan 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. APR is the time-tested rate that people know and expect because it is the legally required standard for mortgages, auto loans, credit cards, student loans and personal loans, including short-term loans.

When small businesses currently shop for financing, they are not able to make an apples-to-apples comparison across financing providers and products. Without standardization of disclosure requirements across lenders, small businesses are more likely to choose higher-cost products. For instance, a research study found that when asked to compare a sample short-term loan product with a 9%“simple interest” rate to a credit card with a 21.9% interest rate, most participants in the study incorrectly guessed the short-term loan to be less expensive. Further research indicates that small businesses can pay APRs of 94%, and as high as 350%, without these high rates being properly disclosed. This is why including both

APR and all financing products in the legislation will better protect small businesses. What's more, a [Federal Reserve study] demonstrated that Black and Hispanic-owned businesses are more likely to use "high-cost" and "non-transparent" financing, referring specifically to merchant cash advances as well as factoring products. This legislation would protect these entrepreneurs, which currently comprise 33% of all small businesses in Maryland.

It is important to note that calculating APR is not burdensome for providers or the marketplace. It does not explicitly prohibit products or providers. Providers can easily calculate APR using common spreadsheet software. Many commercial financing providers across the country already disclose APR without disclosure impeding their operations. Other providers, including revenue-based financing companies, need to disclose annualized yields to their investors without disclosing the true cost of funds, with all fees, for their borrowers. These companies will soon be required to calculate and disclose APR in California and New York. Without the ability to make comparisons across products and providers with terms that small business owners understand from a consumer perspective, fair competition would be stifled, and misleading providers gain an advantage. Once comprehensive disclosures are implemented, the only reason that a provider would stop operating is as a natural consequence of market competition. We can look to the consumer financing marketplace as an example of a vibrant, healthy, and competitive marketplace over fifty years after implementation of the consumer Truth-in-Lending Act and APR disclosure.

In the below appendices, we included a document that dispels some of the common myths regarding transparent disclosure requirements and the need for APR.

We ask you to support SB 0426, swiftly pass this critical small business protection bill through the Maryland Senate Finance Committee, and signed into law as soon as possible. We are happy to serve as a resource as you move forward.

Sincerely,
The Responsible Business Lending Coalition

RESPONSIBLE BUSINESS LENDING COALITION

Claims and Facts in Support of Small Business Truth in Lending

Small business Truth in Lending is supported by leading fintech and bank for-profit lenders, nonprofit CDFIs, civil rights groups, and small business groups. However it may face opposition as well, such as from finance companies that charge relatively higher APRs and do not disclose them.

Claims critical of Truth in Lending were considered extensively in California and New York. After consideration, the legislatures of both states passed strong Truth in Lending Bills by wide, bipartisan margins (132-9 in the New York Assembly and 72-3 in the California Assembly). The following are common claims and facts about small business Truth in Lending:

Claim: Disclosure of the APR is not needed in small business financing

Fact: APR is the only metric that enables comparison of the price of financing of different types, amounts, and term lengths. In response to the rise of high-rate small business financing, the need for transparent disclosure in APR in small business financing has been raised by:

1. Multiple research studies published by the Federal Reserve[1]
2. National Consumer Law Center[2]
3. Bloomberg News editorial board ("Protect Small Businesses from Predatory Lending… The best solution would be for Congress to pass a truth-in-lending law for small business, along the lines of the rules that already exist for consumer loans.")[3]
4. Federal Reserve Governor Lael Brainard[4]
5. Federal Reserve Board of Governors Community Advisory Council[5]
6. The Conference of State Bank Supervisors' Fintech Industry Advisory Panel
7. 110+ industry and nonprofit signatories and endorsers of the Responsible Business Lending Coalition's *Small Business Borrowers Bill of Rights*[6]

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[1] Federal Reserve Board of Governors, "Uncertain Terms: What Small Business Borrowers Fund When Browsing Online Lender Websites," Dec 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

Federal Reserve Bank of Cleveland, "Alternative Lending through the eyes of 'Mom & Pop' Small-Business Owners," August 2015. https://www.clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20150825-alternative-lending-through-the-eyes-of-mom-and-pop-small-business-owners.aspx

Federal Reserve Board of Governors, "Browsing to Borrow: 'Mom & Pop" Small Business Perspectives on Online Lenders," June 2018. https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf

Federal Reserve Bank of Atlanta, "Small Business Credit Survey: Report on Minority-Owned Firms," Dec 2019. https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf This study notes that "Minority-owned firms more frequently applied for potentially higher-cost and less-transparent credit products."

[2] See letter in Appendix B: http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/sb_1235_support_coalition_and_rblc_comment_-_small_business_disclosures_file_no_pro_01-18.pdf

[3] https://www.bloomberg.com/amp/opinion/articles/2018-11-28/confessions-of-judgment-small-business-and-predatory-lending

[4] 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

[5] See page 7, https://www.federalreserve.gov/aboutthefed/files/cac-20181005.pdf

[6] http://www.borrowersbillofrights.org/signatories.html

8. A dozen member companies of the Innovative Lending Platform Association[7]
9. Bipartisan Policy Center[8]
10. Former Democratic and Republican SBA Administrators Karen Mills[9] and Chris Pilkerton
11. US Treasury officials[10]
12. Numerous news articles (e.g. McClatchy, "Even Finance Whizzes Say It's Impossible to Compare Online Small Business Loan Options." June 2018)[11]

Why is APR so critical? The CFPB website explains that: "The APR, or annual percentage rate, is the standard way to compare how much loans cost. It lets you compare the cost of loan products on an 'apples-to-apples' basis."[12] It can be especially useful for comparing different types of financing products. The CFPB encourages credit seekers to compare short-term payday loans to longer-term installment loans or credit cards by focusing on APRs.[13]

Claim: The CFPB and Federal Reserve have published studies stating that APR is misleading, ineffective, or not used by consumers.

Fact: While the quotes do reference arguments made by the Board and CFPB, the way the quotes are used leaves out important context. One of these CFPB studies concerned an instance in which the Board was eliminating a proposed additional APR for credit cards. Another study concerned home mortgage lending. In this instance, the CFPB gave prominence to the interest rate, but retained the APR in another location. Unlike in small business financing, the interest rate and APR are generally very close in mortgage lending—within 0.03% on bankrate.com today. But small business owners are often shown no interest rate or APR at all. According to a report issued by Opportunity Fund, the average alternative small business loan carried an APR of 94%, with some loans carrying APRs upwards of 350%.[14]

Claim: Revenue-based financing companies, also known as "merchant cash advances (MCAs)" can't calculate APR.

Fact: Some MCA companies already disclose APR. Others advertise their high annualized yields to their investors, but don't disclose these annualized percentage rates to their small business customers. Additionally, APR can easily be calculated using common spreadsheet software. All revenue-based

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7 https://innovativelending.org/

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

9 http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf

10 https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx, https://www.progressivepolicy.org/wp-content/uploads/2017/11/PPI_SmallBizCredit_2017.pdf,

11 https://www.mcclatchydc.com/news/nation-world/national/article212491199.html

12 www.consumerfinance.gov/consumer-tools/credit-cards/answers/key-terms/

13 www.consumerfinance.gov/ask-cfpb/my-payday-lender-said-my-loan-would-cost-15-percent-but-my-loan-documents-say-the-annual-percentage-rate-apr-is-almost-400-percent-what-is-an-apr-on-a-payday-loan-and-how-should-i-use-it-en-1625/

14 https://aofund.org/app/uploads/2021/03/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

financing companies will soon disclose APR in California and New York. Our small businesses deserve the same transparency.

Claim: California and New York regulators haven't finalized their regulations because the topic is complicated.

Fact: In June 2022, the California Department of Financial Protection and Innovation (DFPI) released the final rule implementing Senate Bill 1235 - the first state bill extending Truth In Lending Act protections to small business financing. The CA final rule, which requires APR disclosure on any financing to a California-based small business, took effect on December 9th, 2022. DFPI refuted the idea that APR disclosure is too complicated to adopt, saying "While the DFPI recognizes that APR is more difficult to calculate mathematically than ACC, calculating an APR based upon estimated payments is not a complicated task for individuals with minimal training and can be accomplished in widely available spreadsheet programs."

In February 2023, the New York Department of Financial Services (DFS) released the final rule implementing the Small Business Truth in Lending Act (SB5470B) which was signed into law in 2021. The final rule will take effect on August 1, 2023.

Claim: Studies show that small business owners do not understand APRs.

Fact: Four successive Federal Reserve studies have demonstrated that small businesses are currently misled towards higher-cost financing by disclosures that lack APR, and that APR would be among the most helpful disclosure elements to small business owners.[15]

Claim: Use of estimates in small business truth in lending disclosures will open commercial financing providers to a wave of litigation.

Fact: Estimates are anticipated and acceptable. Senator Proxmire, sponsor of the federal Truth in Lending Act, explained on the floor of the Senate in 1967 that in cases when an exact APR cannot be calculated, the Truth in Lending Act "makes it abundantly clear that lenders need only state an approximate annual rate and would not be held to absolute accuracy down to the last decimal point."[16]

Claim: The bill's disclosures related to the practice of double-charging borrowers while refinancing their loans is unnecessary, as this practice, called "double dipping," is not a problem.

Fact: Double dipping is described as an irresponsible practice, even among small business financing providers. See, for example, "Beware: Double Dipping!" by financing company Next.[17]

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[15] See note i

[16] Senator Proxmire, William, "Congressional Record - Senate," Jan 1967.
https://web.archive.org/web/20120415005111/http://www.llsdc.org/attachments/wysiwyg/544/TILA-LH-CR-1967-01-31.pdf

[17] See, e.g. https://next-financing.com/double-dipping/, and, https://www.breakoutfinance.com/double-dipping-explained/

Claim: The regulatory burden of standardized disclosures will cause providers to stop offering financing. Affected providers will not be able to continue operating or offering certain products. The net result will be reduced access to capital for small businesses.

Fact: Private-sector and nonprofit providers in the RBLC are already disclosing APR and other metrics required by the legislation, voluntarily, and it is not impeding their ability to continue operating. Consumer financing providers have had to comply with Truth-in-Lending regulations for decades and the marketplace remains vibrant and diverse. From these examples, we know that the costs of compliance are not overly burdensome for providers. The only reason that a provider would stop operating is as a natural consequence of market competition; some high-cost providers could lose customers after transparently disclosing their pricing and terms.

ETA Opposition Letter & Testimony to S.B. 496.pdf

Uploaded by: Brian Yates

Position: UNF

ELECTRONIC TRANSACTIONS ASSOCIATION
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February 14, 2023

The Honorable Melony Griffith
Chair, Finance Committee
Maryland Senate
3 East, Miller Senate Office Building
Annapolis, Maryland 21401

RE: Opposition to S.B. 496

Chair Griffith, Vice Chair Klausmeier, and Distinguished Members of the Senate Finance Committee,

On behalf of the Electronic Transactions Association ("ETA"), the leading trade association representing the payments industry, I appreciate the opportunity to share our broad concerns with S.B. 496.

ETA supports disclosures that promote transparency and accountability for small business borrowers. However, as drafted, S.B. 496 could be confusing for both online small business lenders and the small business community. Moreover, ETA is concerned that the legislation's effective date will not provide regulators with the necessary time to promulgate rules required by the legislation and will not give providers of commercial financing enough time to comply.

Small businesses are the backbone of the economy and have different needs and objectives than consumers. These businesses often rely on financing to buy inventory, smooth cash flow, expand their marketing, and the ability to obtain financing that enables them to continue to grow. Small business lenders have developed credit products specifically designed to meet those needs and objectives. ETA supports maintaining choice in small business financing, thus allowing these businesses to select, among multiple available options, the best product that suits their needs to secure the capital they need to be successful. S.B. 496, would impose burdensome barriers for providers of commercial financing, and likely result in less options for the very businesses the legislation aims to protect. Reducing options for small businesses in need of capital will hurt, not benefit, these same small businesses. Therefore, ETA would like to work with the committee to incorporate changes to the current bill and oppose S.B. 496 as currently drafted.

Specifically, ETA's concerns with S.B. 496 include:

- **Effective Date**
  - As a threshold matter, S.B. 496 would adopt an effective date of October 1, 2023, which would place an undue regulatory compliance burden on an industry devoting all available resources to sustaining small businesses through uncertain inflationary economic related financial struggles. Given the substantial length of time it took the states of California and New York to adopt regulations, let alone implement them, the short time frame provided by this legislation does not seem adequate. Instead, the legislation should allow for a longer regulatory comment and approval process such as a 180 day compliance period, which will afford providers sufficient time thereafter to make the complex systemic and operational changes required for compliance with new regulations and disclosures of this complex and de novo nature.
- **Definitions**
  - The legislation references numerous phrases and terms, such as "interest accrued," without defining what these terms mean. Clarifications and precise definitions are necessary to provide

certainty of the bill's requirements and to help ensure the ability to provide accurate and meaningful disclosures in compliance with the law.

- The definition of "provider" should exclude "1st party financing;" specifically, where the owner of the product or service is the one offering the financing opportunity.

- The definition of "recipient" should be limited to persons with a principal place of business in Maryland. In order to determine the recipient's principal place of business, providers should be permitted to rely on either (1) a representation from the recipient, or (2) the business address provided by the recipient.

- The legislation defines "total repayment amount" as the "disbursement amount of a sales-based financing transaction plus the finance charge". This definition needs to be refined to address situations where the "total repayment amount" and the "disbursement amount" are not the same, for example, where a provider is paying off a third-party on behalf of the recipient. One example of where the definitions do not take into account all scenarios that actually occur:

    - A provider provides a recipient with a $20,000 loan with a finance charge of $2,000. However, the provider has to pay off a third-party $3,000, which means that the recipient is going to receive a disbursement of $17,000. The disbursement of $17,000 plus the finance charge of $2,000 equals $19,000, not the actual total repayment amount of $22,000.

- **Annualized Percentage Rate**

    - ETA is concerned that S.B. 496, by mandating an annual percentage rate or estimated annual percentage rate (collectively "APR") disclosure for commercial financing, will create significant confusion and uncertainty for Maryland small businesses trying to make informed decisions about the cost of financing products. The Truth in Lending Act ("TILA") was enacted strictly for consumer transactions, not commercial transactions and does not take into account the unique payment features of sales-based financing products, which do not have a fixed term, fixed payments, or have an absolute right to repay.

    - Even the Consumer Financial Protection Bureau in its recent soon to be finalized regulations for Sec. 1071 of Dodd-Frank stated that because these types of products do not have a defined term or a periodic payment amount, it would require a funding company to assume or estimate parts of the APR formula, which only increases complexity. This is not a simple calculation and funding companies have to make a lot of assumptions in order to provide a small business with an estimated APR, which in turn could lead to misleading disclosures, even if that was not the intention of the funding company.

    - On or about December 7, 2022, the Consumer Financial Protection Bureau ("CFPB") issued a Notice of Intent to Make a Preemption Determination under the Truth in Lending Act (Regulation Z) regarding the New York commercial disclosure law ("New York Disclosure"), which requires an APR disclosure. S.B. 496 is modeled on the New York Disclosure. As of today, February 14, 2023, the CFPB has not issued its final ruling on the preemption determination. It does not make sense for S.B. 496 to proceed at this time because the APR disclosure requirement could be preempted by federal law. If parts of the New York Disclosure, which S.B. 496 is based on, are preempted, then S.B. 496 would also be preempted. It would make more sense to wait until the outcome of the CFPB's preemption determination before proceeding.

- On December 2, 2022, a non-profit group filed a lawsuit in California seeking to stop the California Department of Financial Protection and Innovation ("DFPI") from enforcing its commercial financing disclosure regulations ("California Regulations") because the regulations violate the First Amendment rights of its members and because the California Regulations require the disclosure of a finance charge and APR, which are preempted under federal law (the CFPB may also take into account the preemption issue of the California Regulations in the above preemption determination). The First Amendment argument alleges that the non-profit group members are compelled by the California Regulations to provide inaccurate and misleading disclosures and costs of the commercial financing products. The same type of First Amendment claims could be made for S.B. 496 as it compels similar inaccurate and misleading disclosures to be made. Because this case has not been litigated yet and could have a direct impact on S.B. 496, it does not make sense to proceed at this time and wait for the outcome of the litigation.

- As an alternative to APR, ETA urges the committee to consider Total Cost of Capital ("TCC") as the method for disclosing the cost of financing products, which is what matters to small business owners. TCC captures all interest and fees (for certain products that do not charge interest, but rather a fixed fee for capital) that are a condition of receiving capital. TCC is readily calculable and provides the clearest, most accurate basis for comparison among commercial finance options, no matter how they are denominated.

➢ **Calculation of APR for Daily Payment Products**

- The bill states that APR should be calculated in accordance with the TILA. This legislation does not provide the necessary information to calculate APR for a daily payment product. Each month has a different number of days in which payments are collected and providers need to know how many payment days (not calendar days) to assume exist in every month. Simply assuming that payments can be made every calendar day is misleading because it's impossible to make a payment every day and this would assume more payments than actually can be made, thereby artificially inflating the APR, and leading to a misleading disclosure for daily payment products.

➢ **Sales-Based Financing APR Reporting**

- S.B. 496 requires providers of sales-based financing to report to the Commissioner each year (1) the estimated APR rates given to each recipient, and (2) the actual APR rates of each completed sales-based financing transaction. This reporting requirement would be extremely onerous and runs counter to Maryland's intent to adopt regulations substantially similar to those adopted by the New York Department of Financial Services. Under the New York regulations, this report is required only if a provider chooses the opt-in method whereas S.B. 496 would require all providers, regardless of the method they choose, to file an annual report. ETA would request that this reporting requirement either be eliminated or only apply to the opt-in method.

- Moreover, the reporting requirement in S.B. 496 would require the provider to recalculate the APR of each sales-based financing at the time the recipient pays off the balance. ETA does not understand how this type of calculation will be beneficial to anyone. Moreover, the lack of precise definitions for this requirement would have it apply across multiple scenarios. For example, if a recipient decides to pay off a sales-based financing early for any reason, such as the recipient's desire to obtain a new financing product or a sudden increase in the recipient's cash flow, the actual APR will vary (possibly significantly) from the original estimated APR. Additionally, if the sales-based financing were to become charged off or subject to a workout arrangement, the actual APR will vary (possibly significantly) from the original estimated APR. ETA is unclear as to how this requirement would result in producing meaningful data. ETA strongly opposes this requirement and any similar requirement, which could result in a false appearance that a provider is significantly underestimating the APR.

➢ **Disclosure of the Amount of Average Projected Payments Per Month (for periodic payments that are not monthly)**

- The requirement of a monthly payment amount disclosure for products that do not have a monthly payment is problematic for two reasons: (1) it is confusing to the small business; and (2) it expresses a preference for products that ultimately may be more expensive. Requiring disclosure of the actual frequency and amount of payments makes sense and is helpful to the small business. Requiring disclosure of a hypothetical frequency and amount is potentially harmful because of the confusion it could create. Small businesses may not understand why they are receiving a disclosure of a hypothetical monthly payment, and instead assume that they can pay monthly when, in fact, the financing contract requires payments of a different frequency. Adding such confusion is contrary to the purpose of the bill, which is to provide clear and transparent disclosures.

- Requiring disclosure of an average monthly cost for payments that are not monthly expresses a preference for products with monthly payments because products with monthly payments will have a lower average monthly cost than products with daily or weekly payments, as monthly payment products typically have longer terms. This ignores the reality that products with monthly payments may have a higher overall total cost due to the fact that the small business is paying interest over a longer term. Thus, a critical consideration is the overall total cost of a product as well as the periodic payment. More importantly, the disclosure seems likely to cause confusion given that the information would conflict with the written terms of the commercial financing agreement. The average monthly cost of a product is not relevant if it does not reflect the actual payments a small business is required to make, or even the actual monthly cost, given that daily, weekly, and bi-weekly payment frequencies all will have different monthly costs and different averages.

➢ **TILA Disclosure Exemption**

- The New York Disclosure provides that the definition of "commercial financing" **(b) does not include any transaction in which a financier provides a disclosure required by the Truth in Lending Act, 15 U.S.C. § 1601 et seq., that is compliant with such Act**. This provision prevents unnecessary duplication of disclosures from providers who already provide TILA compliant disclosures in commercial financing transactions and encourages uniformity across the country rather than requiring different disclosures in each state, dependent on the specific requirements of a CFDL.

- **Renewal Financing**

  - S.B. 496 requires disclosures for renewal financing that will likely cause confusion. While we are not opposed to disclosing how much of any new financing is being used to pay off existing financing from the same provider, we think it should be a clear, succinct notice or a simple disclosure. The amount of disclosures and explanations required of financing providers is already voluminous and, with additional language and disclosures, will confuse the recipient and increase the likelihood that the recipient might not even read any of the disclosures.

  - The legislation requires providers of renewal financing transactions to disclose any "double dipping" as described in the legislation. First, double dipping is not a formal term and is not widely used throughout industry. Second, the term, as defined, fails to consider how renewal financing works in practice. For example, at the time the disclosure is given, the balance on the existing financing will most likely change prior to consummation of the new financing agreement. Therefore, the amount of the new financing that is used to pay off prior financing could be less if additional payments on the prior financing are made or could be more if a recipient misses a payment. Therefore, ETA suggests replacing the "double dipping" question with a statement that "part of your renewal financing will be used to pay-off your current financing with [name of provider]."

- **Other State Commercial Financing Disclosure Laws**

  - California and New York have passed commercial financing disclosure laws, however, the implementation of their laws took substantial time because of the complexity of the issues. California held eight rounds of comments on proposed regulations and New York made three similar requests, even though they borrowed from much of the work already completed by California. Maryland should also take deliberate and thoughtful time to determine the right law and regulations that would provide the most effective disclosures without overburdening Maryland small business owners.

    - **Timing of Signatures**. For example, a burdensome signature requirement stands out, S.B. 496 requires a recipient to sign the required disclosures "before a provider may allow the recipient to proceed with the commercial financing application" whereas the NY commercial financing disclosure law requires the recipient to sign "prior to consummating a commercial financing". ETA is unclear what Maryland's version of this provision means. It could mean that the recipient must sign the disclosures prior to accepting the offer, in the middle of the application process, prior to funding or some other point in time. Additionally, if a recipient is given multiple pricing options, the recipient should only be required to sign disclosures for the pricing option that the recipient accepts. Ideally, a recipient will be required to sign the disclosure "prior to consummating a commercial financing" as is required by the New York Disclosure. That way, the recipient will be able to sign the disclosures simultaneously with any other documentation and the standards for NY and MD will be consistent.

Given how the uncertain inflationary economy continues to threaten the survival of many Maryland small businesses, now is not the time to pass legislation that would threaten their commercial financing options by creating burdensome and confusing barriers for small business lending providers. S.B. 496 needs more thoughtful deliberation and industry input to create a clear, fair, and uniform regulatory structure. Therefore, ETA urges the committee to reject S.B. 496 in its current form and welcomes the opportunity to work with the sponsor and proponents of the legislation during the interim to develop a legislative proposal that all parties can support.

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

Respectfully Submitted,

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THE CLEAR COST OF CAPITAL:

AN ANALYSIS OF REVENUE BASED FINANCING TRANSACTIONS

February 2023

Report produced by
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Verve Consulting

FLORIDA
State Hispanic Chamber of Commerce

INTRODUCTION

Hispanic-owned businesses play an essential role in our communities, serving as diverse and vibrant economic contributors that create jobs and provide the goods and services we use every day. In my role, I spend much of my time talking with our members to discuss the challenges they face. In this period of economic uncertainty, one issue continually emerges as a top priority: the ability to access capital for their businesses.

Hispanic-owned businesses are a major part of our state and national economy, producing 2.9 million jobs and more than $472 billion in annual receipts across the country. Like all businesses, they will wither if they cannot secure capital when they need it. Having access to a broad range of financial tools from traditional bank loans to credit cards and other products is important for Hispanic entrepreneurs. But one important source of capital is Revenue Based Finance. Depending on the unique needs and circumstances of a business, Revenue Based Finance can provide quick access to capital that can help propel the growth of small- and mid-sized businesses.

With that in mind, the Florida State Hispanic Chamber of Commerce, in conjunction with several other Chambers of Commerce, presents this analysis to shed light on this less familiar source of capital. This analysis provides expert insights into the transparency and accounting aspects of Revenue Based Finance so that business owners and other stakeholders can make more informed decisions.

This analysis shows how Revenue Based Finance can be an important and effective tool for many businesses. It is not the ser todo y terminar todo – the be-all and end-all – of finance options, nor does it attempt to be. But for thousands of businesses, including many members of the Florida State Hispanic Chamber of Commerce and their peers in other states, it offers a realistic option that can help provide timely access to capital.

Sincerely,

Julio Fuentes

Julio Fuentes
President
Florida State Hispanic Chamber of Commerce

OVERVIEW

Revenue Based Finance (RBF) is a highly effective instrument that can quickly provide an infusion of funding for businesses wishing to capitalize on an opportunity, purchase new resources to meet higher demand, replace failed equipment, or otherwise address unanticipated needs. RBF offers numerous advantages over traditional loans, not least of which is a very short turnaround time for companies to receive the funds. However, policymakers in some states mistakenly believe RBF instruments should be regulated in the same way as regular business loans, including cost disclosures based on annual percentage rates (APR). This analysis details how Revenue Based Finance transactions work, why they are better for companies in many situations, and – most significantly – how and why APR is not a meaningful or viable method of accounting for the costs of an RBF transaction.

BACKGROUND

Verve Consulting LLC (Verve), a duly licensed CPA firm in the State of Florida, is pleased to provide an independent perspective on Revenue Based Finance (RBF) transactions and whether Annual Percentage Rate (APR) is a useful metric for businesses considering an RBF transaction to meet short-term liquidity requirements. This report provides a brief description of RBF transactions and provides a few examples, as well as some discussion about the unique characteristics of RBF transactions. The analysis also provides details about why these transactions are not considered loans, a position that has been upheld in courts of law.[1]

Next the report discusses the existing state regulations and how those are anticipated to affect the industry. From there, the analysis will dive deep into APR and the associated APR equations, concluding that there is not enough information to calculate a reliable estimate of APR within tolerances. This is due to the variables in the APR equation, most of which are determined and held constant in loan transactions but are not held constant by RBF transactions due to the nature of these transactions. Finally, the analysis will conclude that RBF transactions are important to businesses as an alternative to more traditional transactions that businesses use to increase their short-term liquidity. Some states have promulgated regulations that are unlikely to impose significant compliance burdens and costs on RBF companies, while others have promulgated regulations that will almost certainly impose significant compliance burdens and costs on RBF companies. It is important to maintain a relatively low-friction regulatory environment to keep this relatively low-friction method of enhancing businesses' short-term liquidity as a solid option.

[1] (No. 3D19-1643) CRATON ENTERTAINMENT, LLC, et al., Appellants, v. MERCHANT CAPITAL GROUP, LLC, et al., Appellees. – No. 3D19-1643.

WHAT IS AN RBF TRANSACTION?

For purposes of this analysis, we will identify a business that needs short-term liquidity and will be the recipient of funds from an RBF company as the "seller." Such business would be a party to an RBF contract by selling a portion of its revenue and delivering it via future cash flows to the "buyer" RBF company. Reasons why sellers would enter such transactions include, but are not limited to, capitalizing on an opportunity to achieve competitive advantage; expanding operations to meet demand; and replacing an unexpected failure of equipment used in company operations.

RBF transactions have unique characteristics compared to other methods of increasing liquidity, including:

A. The borrower's obligation in a traditional loan is to repay the agreed-upon amount, with each scheduled payment composed of principal and interest. Certain variables are determined at the outset of the transaction, such as interest rate, maturity date, compounding frequency, etc.[2]

B. The seller's obligation in an RBF transaction is to deliver a percentage of future revenue, provided such revenue exists and the seller is paying back an amount originally advanced, plus an additional fixed fee. The agreed-upon total amount to be paid back to the buyer is delivered by way of the seller's future cash flows.[3]

Seller is granted flexibility and buyer's capital is completely at risk –

As opposed to more traditional products that help businesses meet their liquidity needs, the seller remits a contractually specified percentage of its future revenue. If revenue and subsequent cash flow decreases, then the seller has the right to correspondingly decrease its remittances to the buyer.

The buyer takes the risk that the seller's sales levels may decline, as well as the risk that the seller may fail or go bankrupt – resulting in a loss to the buyer.

Example transaction: After receiving an application and conducting the underwriting process, a buyer offers to buy 10% of a seller's future revenue up to $10,000 – the transaction will terminate when the seller successfully generates $100,000 in revenue and remits 10% of that revenue to the buyer. The milestone may be reached in a month, it may be reached in a year, or it may never be reached. The immediate funds that the seller receives from the buyer could be anywhere from about $6,000 up to $9,000, depending on the business' need, transaction costs, the buyer's required rate of return, and the seller's qualifications as assessed by the buyer through the application and underwriting processes.

[2]Based on Cornell Legal Encyclopedia Definition of "Debt"
[3]Based on Legal Comment to Draft of California Law

There are many benefits to a business that decides to use an RBF transaction to meet its short-term liquidity needs.

RBF Transactions:

1. Disburse funds quickly
2. Generally are not secured by collateral
3. Do not require equity dilution or the sale of ownership interest
4. Do not bind the business over the long term – most are completed within a year
5. Feature a fixed repayment amount that is adjustable at the request of the business if its cash flow declines during the term of the transaction.

	Revenue Based Financing	Bank Loan	Venture Capital
Speed	Within days	1-3 months	2-6 months
Cost	Flat fee	Variable interest rate based on risk profile	Equity in the company forever
Risk	Incentive alignment	Personal guarantee and/or collateral	Valuation risk and ownership control
Accessibility	Broader than other instruments	Cash flow and size limitations	Select businesses with high potential (e.g. tech, finance, etc.)
Flexibility	Payments adjust based on business revenue	Rigid payments with late fees	Must prioritize shareholder value

[Financing the Internet Entrepreneur of Tomorrow: Our Investment in Wayflyer]

STATE REGULATION

Four states have passed laws regarding RBF transactions: New York,[4] California,[5] Virginia,[6] and Utah,[7] and several others are in the process of considering legislation.[8] Virginia and Utah have passed legislation that focuses on disclosures informing the seller of all costs, requirements, and obligations under such a contract and that do not appear to impose significant additional burdens or costs on the buyer. These disclosures have routinely been a part of the information explicitly disclosed to sellers in the specific offer as well as the contract.

Both Virginia and Utah have registration provisions that require actors in the RBF space – including buyers and Independent Sales or Service Organizations (ISOs), to register with the state. These individuals connect sellers to buyers in most RBF transactions (akin to brokers in other transactions). In compiling this analysis we interviewed many industry representatives, and they largely view the registration provisions passed by Virginia and Utah favorably and a step toward greater transparency and accountability, which is similar to other licensed or registered professions.

Laws in New York and California require a buyer to determine and disclose an estimated annual percentage rate. These laws use the words "annual percentage rate" or the abbreviation "APR," expressed as a yearly rate, inclusive of any fees and finance charges, and calculated in accordance with section1026.22 of Subpart C of Regulation Z (12 C.F.R. s.1026.22) of the federal "Truth in Lending Act" (TILA) (15 U.S.C. s.1601 *et seq*.) based on the estimated term of repayment and the projected periodic payment amounts.

Why RBF Contracts should not include APR

APR is defined in Federal Consumer Credit laws

RBF is a commercial liquidity product not consumer credit and not a loan.

No. 3D19-1643

Since these transactions are not loans there is no stated interest rate for these transactions Nominal, Effective, APR, or otherwise. Forbes – What You Should Know About RBF

An interest or a discount rate is important, because interest is a key component of the APR formula per Appendix J of Regulation Z. Without an interest or discount rate APR cannot be calculated.

[4] Legislation | NY State Senate (nysenate.gov)
[5] Codes Display Text (ca.gov) & CALIFORNIA CODE OF REGULATIONS TITLE 10, CHAPTER 3
[6] § 6.2-2231. Disclosure requirements (virginia.gov)
[7] Utah Code Section 7-27-202
[8] Connecticut General Assembly Banking Committee Meeting March 10, 2022 & Transcript & other state bills

TILA is a federal regulatory measure created exclusively for consumer protection and applicable only to consumer debt and credit products. This provision in the California and New York laws, in our view, imposes burdensome compliance requirements and costs by requiring buyers to determine an estimated APR that can be calculated in one of two ways:

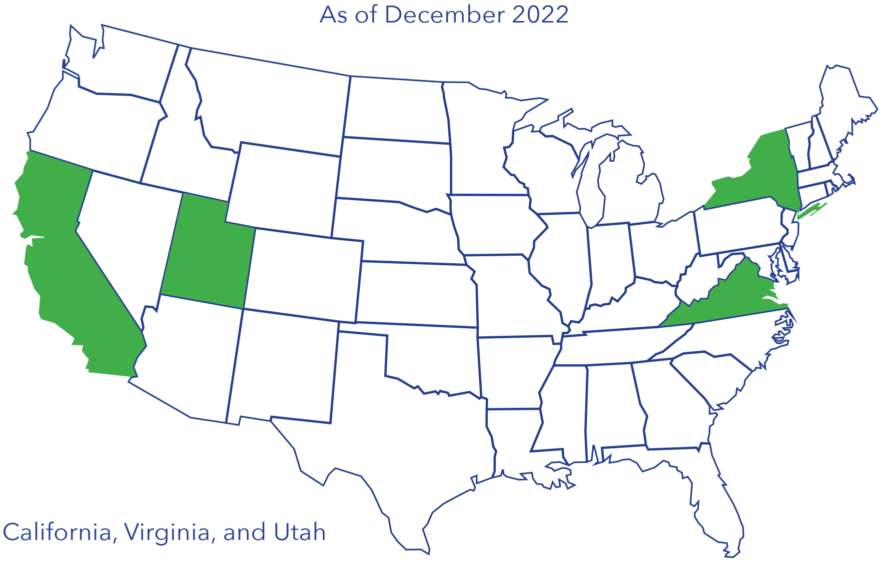
1. Using the U.S. rule method (calculate interest first, add to principle, apply payment, subtract from principle) [APR U.S. Rule Method]

2. Using the actuarial determined method per Appendix J of Regulation Z [APR Actuarial Method]

Either of these methods will only produce a reliable result if some of the terms in the equation can be held constant. However, for RBF transactions they are not held constant because of the favorable nature of the terms to the seller.

States That Have Passed Laws Regarding RBF Transactions

As of December 2022



New York, California, Virginia, and Utah

ANNUAL PERCENTAGE RATE

An Annual Percentage Rate (APR) is a metric used to compare different consumer loans and other consumer credit products. Revenue Based Finance (RBF) transactions are not intended for consumers and are not loans or credit products.[9] That is enough, in our opinion, to conclude that APR is not applicable to RBF transactions. However, additional details further emphasize this point.

In 1968, Congress passed the Truth in Lending Act, which mandated that lenders disclose information about loans and credit products to borrowers. One important aspect of that disclosure was APR, which aims to give consumers a simple, accurate way to compare loan rates between lenders. The original APR calculation (now called the actuarial method) can be found in Appendix J of Regulation Z of the Truth in Lending Act. However, the government allows lenders to calculate APR using the U.S. Rule Method, which diminishes APR's value as a one-to-one comparison.

The different methods exist because the national government is divided into three branches: legislative, executive, and judicial. The legislative branch is Congress, and they write laws like TILA. The executive is the President and administrative agencies, and the leaders of the following agencies are typically initially nominated by the President and then confirmed by the legislative branch: the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, and FDIC. These agencies created more specific regulations, such as Regulation Z, based on acts passed by Congress. The judicial branch is the court system, which resolves disputes about how laws and regulations are implemented and enforced.

In short, Congress passed TILA and then executive agencies codified it into Regulation Z, which includes Appendix J. This amalgamation of legislation, regulation, and case law often creates a more complex and convoluted environment in which the users of credit products must navigate to compare options.

ACTUARIAL METHOD

The rules for computing an Actuarial APR, along with numerous examples, are specified in Appendix J of Regulation Z. These rules include a special calendar method (commonly called the "Federal Calendar") for counting time between cash flows, as well as how loans are to be amortized.

U.S. RULE METHOD

Regulation Z also allows the lender to disclose an APR computed according to the U.S. Rule. This rule forbids the capitalization of interest during the amortization of a loan – principal can accrue interest, but interest cannot accrue more interest. The U.S. Rule method does not, however, specify the calendar method to be used in counting time between cash flows.

[9] NO. 3D19-1643 & Forbes – What You Should Know About RBF

Many lenders employ the U.S. Rule method to calculate their interest accrual, but different lenders may use different calendar methods for counting time. If a lender discloses a U.S. Rule APR and uses the same calendar method to compute interest, the APR and interest rate should be the same, provided there are no contributions to finance charges other than interest.

The U.S. Rule method of calculating APR is not outlined in Appendix J because there is no single calculation that will compute an accurate APR in all scenarios.

Actuarial Method Calculation Basics

The actuarial method calculates APR as the interest rate that will cause the present value of future cash flows (payments) on a loan to equal the loan amount. The interest rate is calculated using an iterative method because there is no easy way to calculate exactly what it should be. Because of this, software products use iteration and recursion to guess at the interest rate and then raise or lower it to make the sum of the present value of future cash flows (payments) equal the advance amount, or at least converge to an amount that very closely approximates the advance amount, at the end of the term of the loan.

This causes the calculation of truth-in-lending (TIL) numbers to take longer than you might expect because sometimes it takes numerous iterations to arrive at the correct interest rate, which is used to determine APR.

Once a rate is calculated using such amortization software, the calculations for each transaction should match the APR calculated by the Federal Financial Institutions Examination Council's (FFIEC) APR Computational Tool, as recommended by the FDIC and OCC.

How to Calculate APR Unit Periods and Odd Days for Irregular First Periods

If the difference between the contract date and the first due date is not equal to a standard unit period, then the loan has an irregular first period. If this is the case, one will need to calculate the number of unit periods in the term of the contract and the number of odd days in the first period in order to calculate APR. This will have an impact on the disclosed APR.

For Revenue Based Finance transactions, the unit period is days. Based on the transactions we reviewed for this report, there typically is no difference between the contract date and the first due date, so this is not an issue unless the buyer includes provisions to delay collections from the seller until a specified time after the contract date. This could be possible, and further emphasizes the uniqueness and complexity of calculating APR for these transactions.

The California and New York laws did not entirely consider the impact of their APR disclosure requirements, as New York clearly stated that such requirements do not impose significant short-term costs on buyers.[10] However, these transactions contemplate the need for sellers to reduce their initially agreed-upon payment levels and extend the agreed-upon payment schedule. This causes difficulty for buyers trying to comply with provisions for disclosure accuracy, since the equations and software are not set up to effectively handle inconsistent payments. Inconsistent payments require that each payment is discounted back to a present value,

[10] HTTPS://WWW.DFS.NY.GOV/SYSTEM/FILES/DOCUMENTS/2021/10/RP_23NYCRR600_SAPA_202110.PDF

and the equation to discount single payments still requires a discount (interest) rate. This rate will be difficult to determine and will likely be part of a large initial cost that neither California nor New York considered. Buyers will need to engage an actuary to determine the interest rate and subsequent APR. The process will be much like how an insurance company determines the premium level in order to remain solvent.

To demonstrate the difficulty and cost of compliance, here is one potential path to compliance following the California and New York laws:

Using historical data, an actuary will likely stratify the population by purchase amount and factor, calculating the interest rate and APR based on the assumptions in the original contract for each transaction. Then, to determine a rate for disclosure of estimated APR, the actuary will likely determine risk factors. The risk factors will be calculated via probabilities based on the number of transactions in each strata that: perform to term; perform to a point and fail; perform to a point and require reduced remittances but perform to an extended term; perform to a point and result in a refund and a new transaction with different terms but the transaction remains in the same strata; perform to a point and result in a refund but the transaction migrates to a new strata; and any other conceivable outcome of a contract, etc. The risk factor will aid in determining the most common transaction outcomes in each stratum,[11] and the median of the APRs for those transactions will be the best estimate for APR disclosure.[12]

APR ADDITIONAL DETAILS

From a qualitative perspective, studies conducted by the Consumer Financial Protection Bureau, the Federal Reserve, and independent parties indicate that consumers and small businesses appreciate clear disclosures about the cost of capital. The simplest disclosure is the actual dollar amount the business will be paying back in the future in exchange for the smaller amount advanced today. Those studies indicate that APR is not as useful to consumers as actual dollar amount disclosures, so for consumer credit products APR is disclosed on the third page of some consumer credit disclosure forms, such as mortgage loan estimates and closing disclosure forms. As such, APR is unlikely to be considered a useful metric for commercial transactions.

From a quantitative perspective, APR requires determination and disclosure of variables that are not contemplated in RBF transactions. The only variables that exist for APR calculations in an RBF transaction that are held constant are the initial disbursement (advance) to the seller from the buyer (Present Value, or PV) and the sum of the payments to be provided to the buyer by the seller (payments) (Future Values, or FV). The remaining variables – maturity or term (N), compounding or unit periods (T), interest rate (I), and payment (PMT) – are not held constant due to the nature of RBF transactions.

[11] This will likely have an added benefit of providing richer predictive information to the buyer's underwriting department but will come at a substantial recurring cost.
[12] This entire paragraph simplifies and summarizes concepts described in these two resources 1 and 2
[13] Chin, A., & Bruine de Bruin, W. (2019)
[14] Form Samples & CFPB General Counsel Discussion including a claim that APR is not useful (talking over slide 6 about pg. 3 of disclosure)

(8) General equation.

The following equation sets forth the relationship among the terms of a transaction:

$$\frac{A_1}{(1+e_1 i)(1+i)^{q_1}} + \frac{A_2}{(1+e_2 i)(1+i)^{q_2}} + \dots + \frac{A_m}{(1+e_m i)(1+i)^{q_m}} = \frac{P_1}{(1+f_1 i)(1+i)^{t_1}} + \frac{P_2}{(1+f_2 i)(1+i)^{t_2}} + \dots + \frac{P_n}{(1+f_n i)(1+i)^{t_n}}$$

To determine APR, Regulation Z prescribes the present value of future cash flow equation shown above. This equation requires a periodic interest rate (i); from the buyer's perspective it is a discount rate, which represents the time value of money. When applied to each payment in the series by way of the following simplified (right side) part of the general equation in appendix J [P/(1+i)^t] it discounts each payment, so the sum of the discounted payments equals the present value of the advance(s) (A_m) (left side). For a short-term contract with daily compounding, this will produce a rate that will be comparatively high relative to a long-term contract with monthly compounding, holding every other variable constant.

A most significant thing to keep in mind is that in RBF transactions there is no contemplated interest rate. Instead, the payments are required to adjust based on the seller's request that will extend the term of the contract, so it is difficult to contemplate an APR when by its nature the transaction is meant to be fluid and favorable to the seller.

Example transactions: RBF Terms

Buyer Advanced Amount:	$17,000
Seller Remittances (Payments) Total:	$22,950
Total Finance Charge:	$5,950
Payment Term:	115 Business Days
Payment Amount:	$199.57

APR Tool New Loan

ACCOUNT INFORMATION — LOAN INFORMATION — PAYMENT SCHEDULE — RESULTS

RESULTS

ACCOUNT INFORMATION

Prepared by	Date	Borrower's Name	Name of Lender	Original Creditor
Verve	0830/2022	GDA	Verve	Verve

DISCLOSURE INFORMATION - OUTPUT	LOAN INFORMATION - ORIGINAL INPUT
Amount Financed $17,000.00	**Amount Financed** $17,000.00
Finance Charge $5,900.00	**Disclosed (estimated) APR** 200.000%
Total of Payments $22,950.55	**Disclosed Finance Charge** $0.00
Annual Percentage Rate 199.7088%	**Loan Secured by Real Estate or Dwelling** No
Loan Regularity Regular	**Payment Frequency** Actual Days (Installment Loan)
	Days In Unit Period 1
	Loan Subject to TRID No

PAYMENT FREQUENCY

Payment Stream	Payment Amount	Number of Payments	Whole Unit Periods	Odd Days
1	$199.57	115	1	0

No stated interest rate is given, so one must be determined in order to comply with the California and New York laws using the iteration process provided in Appendix J, which is the same way the RATE function works in various financial calculators and Microsoft Excel.

However, this approach requires one to assume:

1. That the payments are going to remain the same for the term of the contract
2. The term of the contract is known and certain
3. The payment frequency will remain unchanged for the term of the contract

APR = 199.7% – None of the assumptions leading to the calculated ARP are in line with RBF transactions. The resultant APR is exceedingly high because this would be the rate required for such a short term with daily compounding (unit periods) – but it is also the calculated rate for the period 115 days multiplied by 365 because APR is an annualized rate.

To compare with the previous transaction, here are loan terms for a 5-year unsecured commercial loan paid off in 60 monthly payments:

Lender Advanced Amount:	$17,000
Borrower Remittances (Payments) Total:	$22,950
Total Finance Charge:	$5,950
Payment Term:	60 Monthly (5-Years) Payments
Payment Amount:	$382.50
Stated Interest Rate:	12.5%

APR Tool New Loan

ACCOUNT INFORMATION — LOAN INFORMATION — PAYMENT SCHEDULE — RESULTS

RESULTS

ACCOUNT INFORMATION

Prepared by	Date	Borrower's Name	Name of Lender	Original Creditor
Verve	08/29/2022	GDA	Verve	Verve

DISCLOSURE INFORMATION - OUTPUT	LOAN INFORMATION - ORIGINAL INPUT
Amount Financed $17,000.00	**Amount Financed** $17,000.00
Finance Charge $5,950.00	**Disclosed (estimated) APR** 12.500%
Total of Payments $22,950.00	**Disclosed Finance Charge** $0.00
Annual Percentage Rate 12.5041	**Loan Secured by Real Estate or Dwelling** No
Loan Regularity Regular	**Payment Frequency** Monthly (Installment Loan)
	Loan Subject to TRID No

PAYMENT FREQUENCY

Payment Stream	Payment Amount	Number of Payments	Whole Unit Periods	Odd Days
1	$382.50	60	1	0

APR = 12.5% – This rate is lower than in the previous example because the term is longer than a year and it is multiplied by 12, due to the monthly rather than daily compounding. However, the rigid nature of APR still requires an annualized rate. Furthermore, each of these variables is determined at the outset of the loan transaction, and the borrower (as opposed to the seller in an RBF transaction) has much less flexibility – if it can get a bank to lend it money at all. The borrower would be required to pay on the schedule exactly the amount agreed and would be bound to pay back the loan for five years, and it would be unlikely that the borrower would get the funds within a reasonable timeframe if it needed the funds quickly. In contrast, as mentioned above, an RBF transaction is likely to fund within 2-3 days.

As part of this analysis, we provide other examples that demonstrate the sensitivity of APR when fees and other finance charges are part of the transaction. The rules generally state that APR should be calculated by reducing the PV of the advance by fees imposed by the buyer, so if there were $800 worth of fees the advance amount goes from $17,000 to $16,200. This has the effect of increasing the finance charge by $800, but the APR goes from 199.7% to 234.06%. See Appendix A.

We assured quality of the calculations in these examples by using the Federal Financial Institutions Examination Council's APR Tool (ffiec.gov), which was constructed using the logic in Appendix J.

CONCLUSION

It is important to maintain a low-friction regulatory environment to keep Revenue Based Finance transactions as a seamless and quick method enabling businesses to increase their short-term liquidity. While some jurisdictions seek to apply annual percentage rate (APR) in the RBF space, the Consumer Financial Protection Bureau has stated that consumer testing has shown that APR is not as useful a metric as other disclosures. This can also be seen on many disclosure forms, where APR is relegated to the third page behind other more useful disclosures. Furthermore, it is important to remember that key variables that are required to calculate APR – including interest rate, payment, and term – are either not present in an RBF transaction, or are subject to later adjustment at the request of the seller.

As such, it is our view that APR should not be a required disclosure for RBF transactions. We believe that Utah and Virginia have done an excellent job with their disclosure requirements, including plainly stating the total of applicable charges, the total dollar amount of the advance, the total dollar amount of revenue to be delivered by the end of the contract, the timing of the delivery, the term of the contract, and the planned initial amount of daily revenue to be delivered. RBF transactions are an important and effective tool for many businesses, and the approach of these two states – unlike the schemes adopted in California and New York – will foster continued benefits for companies in need of the rapid infusion of funding available through RBF.

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Calculation Resources:

https://www.fdic.gov/regulations/laws/rules/6500-3550.html
http://www.consumerfinance.gov/eregulations/1026-J/2013-30108_20150718#1026-J-a
http://www.consumerfinance.gov/eregulations/1026-J/2013-30108_20150718#1026-J-b-4-i
http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol3/pdf/CFR-2015-title12-vol3-part226-appJ.pdf
http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/truth-in-lending-handbook.pdf

Actuarial Resources:

https://www.soa.org/globalassets/assets/library/monographs/50th-anniversary/product-development-section/1999/january/m-as99-3-05.pdf
https://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=joap

MD Testimony - SB 0496.pdf
Uploaded by: Patrick Siegfried
Position: UNF

Rapid FINANCE
Where Small Business Goes Big

February 15, 2023

Chairwoman Melony Griffith
Miller Senate Office Building, 3 East Wing
11 Bladen St., Annapolis, MD 21401
Annapolis, MD 21401

SB 0496 – Oppose

Dear Chairwoman Griffith and Members of the Finance Committee:

Chairwoman Griffith and Members of this committee, my name is Patrick Siegfried and I am here today on behalf of Rapid Financial Services, LLC ("Rapid"). Founded in 2006, Rapid is headquartered in Montgomery County, Maryland. Rapid is a proud supporter and finance provider to small businesses nationwide. Rapid believes legislation impacting commercial finance should be tailored to the needs and use cases of the small business customers that utilize these products.

Multiple states, including Maryland, are discussing legislation that would require disclosures for certain commercial finance transactions. California was one of the first states to pass such commercial finance laws. The regulations implementing California's disclosure laws were recently finalized and came into effect December 9, 2022. While we are in the early days of their implementation, the requirements of the regulations and the confusion they have created within the industry have caused some finance providers to cease or pause funding in California. Similarly, New York recently finalized its regulations which go into effect August 1, 2023. Unfortunately, the regulations of New York differ from California's regulations thereby creating different and sometimes conflicting disclosure requirements between the states. These differing and conflicting disclosure requirements are likely to cause more finance providers to cease or pause funding to small businesses. The same result has occurred in Virginia and Utah after they passed disclosure laws that differ substantially with each other as well as the laws of California and New York. SB 0496 would bring these issues to Maryland.

In response to these concerns, the Uniform Law Commission has recently created a study committee to conduct a comprehensive review of commercial finance disclosure laws. The committee will "study the need for and feasibility of a uniform or model act providing for standardization of disclosure requirements for commercial financing (i.e., traditional bank loans as well as other products such as factoring and revenue-based financing). The study committee will assess whether a uniform or model act could help increase efficiency, reduce compliance costs, and reduce uncertainty regarding the governing law for transactions that may involve parties located in two or more states." The committee's work will be critical to creating a model framework for all states to follow and implement.

While Rapid is supportive of effective disclosure legislation, we urge this committee to allow time for the Uniform Law Commission to complete its work and provide a draft uniform law that all states can work from. Standardized requirements will result in more meaningful disclosures to the small businesses that seek commercial financing and minimize the compliance costs for providers. Though we oppose SB 0496, we are committed to working with this committee, and the sponsor, to create thoughtful and comprehensive legislation to regulate commercial financing.

Sincerely,

Patrick Siegfried
Deputy General Counsel
Rapid Financial Services, LLC