SENATE RULES COMMITTEE SB 1235

Office of Senate Floor Analyses
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THIRD READING

Bill No: SB 1235
Author: Glazer (D)
Amended: 5/10/18
Vote: 21

SENATE BANKING & F.I. COMMITTEE: 4-1, 4/18/18
AYES: Bradford, Hueso, Lara, Portantino
NOES: Vidak
NO VOTE RECORDED: Gaines, Galgiani

SENATE JUDICIARY COMMITTEE: 4-1, 5/8/18
AYES: Jackson, Hertzberg, Monning, Wieckowski
NOES: Anderson
NO VOTE RECORDED: Moorlach, Stern

SUBJECT: Commercial financing: disclosures

SOURCE: Author

DIGEST: This bill requires providers of commercial financing, as defined, to provide disclosures about the cost of that financing to the recipients of the financing, as specified.

ANALYSIS:

Existing law:

1) Provides for the California Financing Law (CFL; Financial Code Section 22000 et seq.), administered by the Department of Business Oversight, which regulates secured and unsecured, consumer-purpose and commercial-purpose loans made by nondepository institutions, as specified, and requires persons engaged in the business of making consumer and commercial loans, as defined, to obtain finance lender licenses.

2) Defines commercial loan and commercial open-end credit program under the CFL (Financial Code Sections 22502 and 22650).

3) Provides that every loan with a principal amount under $5,000, which is regulated under the CFL, is considered a consumer loan (Financial Code Sections 22203 and 22204).

This bill:

1) Creates a new division within the Financial Code, titled "Commercial Financing Disclosures" (Division 9.5, Financial Code Section 22800 et seq).

2) Defines the terms commercial loan and commercial open-end credit program as they are defined in the CFL, and defines an accounts receivable purchase transaction as a transaction of $5,000 or more as part of an agreement requiring a recipient to forward or otherwise sell to the provider all or a portion of accounts, payment intangibles, or cash receipts that are owed to the recipient or are collected by the recipient during a specified period or in a specified amount.

3) Defines commercial financing as an accounts receivable purchase transaction, commercial loan, or commercial open-end credit program intended by the recipient for use primarily for other than personal, family, or household purposes. For purposes of determining whether financing is commercial financing, the provider may rely on any written statement of intended purpose signed by the recipient and is not required to ascertain whether the proceeds of the commercial financing are used in accordance with the recipient's statement of intended purposes.

4) Defines a provider as a person who extends a specific offer of commercial financing to a recipient. Clarifies that the term provider also includes a nondepository institution, which enters into a written agreement with a depository institution to arrange for the extension of commercial financing by the depository institution to a recipient via an online lending platform administered by the depository institution (i.e., the nondepository institution that helps facilitate commercial financing through a bank partnership model).

5) Applies the provisions of this bill to each provider that consummates or arranges more than five commercial financing transactions during a calendar year. Expressly exempts depository institutions, commercial financing transactions secured by real property, and commercial leasing transactions, as defined, from the provisions of this bill.

6) Requires each provider to disclose all of the following information to a recipient at the time the provider extends a specific commercial financing offer to that recipient, and to obtain the recipient's signature on the disclosure before consummating the commercial financing transaction:

   a) The principal loan amount or the purchase price, less any fees paid to or retained by the provider or an affiliate of the provider for originating or processing the commercial financing transaction. This must be labeled "Total Amount of Funds Provided."

   b) The total amount of funds to be paid by the recipient pursuant to the financing agreement, assuming all payments are made when required. This amount, which must be labeled "Total of Payments," must include all unavoidable fees and charges, and must clarify that it does not include fees the recipient may avoid, such as late fees or returned payment fees.

   c) The total dollar cost of the commercial financing transaction, which must be labeled "Total Dollar Cost of Financing," and must be calculated by subtracting the total amount of funds provided from the total of payments.

   d) For products with fixed periodic payments, the term of the financing product in total days, and for products with variable payments and no fixed term, the estimated term of the financing product in total days, as assumed by the provider in the underwriting process. This must be labeled "Term" or "Estimated Term."

   e) For commercial financing with fixed, non-variable payments, the frequency and amount of each payment, and for commercial financing with variable periodic payments, the frequency of payments and the method by which payments are calculated. This must be labeled "Payments."

   f) A statement of whether there are any costs or discounts associated with prepayment of the commercial financing product, including a reference to the paragraph in the financing agreement that creates the contractual rights of the parties related to prepayment. This disclosure must be labeled "Prepayment."

7) Provides that in addition, until January 1, 2023, providers of commercial loans, commercial open-end credit programs, and certain types of accounts receivable purchase transactions (i.e., merchant cash advances) must include an Estimated Annualized Cost of Capital (EACC) in the disclosures they are required to provide recipients, at the time they extend specific commercial financing offers

to those recipients. Providers of other types of accounts receivable purchase transactions (i.e., factoring) are not required to calculate or disclose an EACC.

a) The Estimated Annualized Cost of Capital is defined as the total cost of capital, expressed as a percentage of the amount financed and presented as an annual equivalent.

b) For open-end lines of credit, the EACC must be calculated by multiplying the monthly periodic rate applied by the provider to the outstanding balance by 12.

c) For other types of commercial financing (i.e., for closed-end loans and merchant cash advances), the EACC must be calculated by: (i) dividing the total dollar cost of financing by the total amount of funds provided; (ii) multiplying the result of (i), above, by 365; (iii) dividing the result of (ii) by the term or estimated term of the financing in days; and (iv) multiplying the result of (iii) by 100.

d) Providers are required to round the EACC to the nearest whole number and to include the following disclosure in connection with the EACC: "This estimate includes all charges and fees incurred for the financing, assuming you make all payments when scheduled and adhere to the terms of the agreement. This number is based on the estimated term. If the actual term is shorter than estimated, the annualized cost of capital may be higher than shown, and if the actual term is longer than estimated, the annualized cost of capital may be lower. This is not an Annual Percentage Rate (APR)."

8) Provides that recipients may elect to receive the disclosures described in 6) and 7), above, either electronically or in writing. If the disclosures are provided in writing, they must be printed in at least 10-point font. If they are provided electronically, they must be provided in a format that allows the recipient to review them on an electronic device that the recipient can independently access, and in a format that allows the disclosures to be printed out by the recipient in a minimum of 10-point font.

Comments

This bill requires disclosures to be provided in connection with four different types of commercial financing: closed-end loans; open-end lines of credit; merchant cash advances; and factoring (though small businesses using factoring would not be provided with an EACC).

Understanding the different types of financing used by small businesses. Closed-end loans are the most familiar of the four types of financing. These loans are offered in a fixed amount, for a fixed term, at a fixed (or variable) interest rate, and require money to be paid back on a fixed schedule. Open-end lines of credit are familiar to anyone who has taken out a home equity line of credit. The borrower is provided with a credit line, which can be drawn down in whole or in part, at the borrower's discretion and on the borrower's desired schedule. Fees may be charged in connection with each draw. Open-end lines of credit typically lack fixed terms; they are often available, until closed by either the borrower or the creditor. Interest on open-end lines of credit is owed on the amount drawn, not on the total amount of the credit line. Payments are due on a fixed schedule.

Merchant cash advances take many different forms, but generally involve the provider extending a fixed amount of money (the advance) to the small business (i.e., the recipient), in exchange for a percentage of the small business's future receipts. The amount owed by the small business (a set percentage of its receipts) is calculated and payable on a daily, weekly, or monthly schedule or on another schedule mutually agreed to by the provider and the small business. Although the percentage the small business owes the provider remains constant, the amount paid to the provider varies, based on the business' daily, weekly, or monthly cash flows. Because the payments owed by the small business closely track receipts received by the business from its customers, merchant cash advances are popular among businesses with seasonal or other types of irregular cash flow. Rather than taking out a loan and having to make a fixed payment every month, regardless of its cash receipts, a business knows it will owe no more than a set percentage of its receipts. Because of the way in which they are structured, merchant cash advances do not have fixed terms; they last as long as it takes the small business to pay back the advance.

Factors, also known as factoring or accounts receivable financing, can also take many different forms, but generally involves the provider purchasing a set amount of accounts receivable, in advance, at a discount, from a business. The discount price builds in a profit margin for the factor and is also intended to reflect the cost of capital (the business is receiving the money immediately, while the factor must wait to collect the receivables) and to reflect the likelihood that some portion of the receivables will not be collectable by the factor. Because of the way in which factoring arrangements are structured, there is no set term or repayment amount; the purchase price of the accounts is paid to the small business up front, and the factor collects receipts over time as customers of the business make payments on the underlying accounts.

Understanding the different types of small business credit providers. Entities providing commercial financing run the gamut from traditional banks acting on their own behalf (e.g., Wells Fargo), to banks acting in partnership with nondepository institutions (e.g., Celtic Bank, acting in partnership with Kabbage), to nondepository institutions making direct loans under the CFL (e.g., Ally Financial), to nondepository institutions making cash advances or offering factoring, activities that are not, generally speaking, regulated under the CFL (e.g., Rapid Advance).

Because the vast majority of small business financing available in California is offered by companies that are not subject to the CFL, SB 1235 is drafted outside of that law. This bill requires all of the aforementioned entities, other than banks acting on their own behalf, to provide disclosures. This is significant, not only because this bill extends to two types of products not currently regulated under the CFL (merchant cash advances and factoring arrangements), but also because this bill attempts to do something not previously attempted in California: regulate the so-called "bank partnership" model (also called the "rent-a-charter" model, although the businesses that use these models prefer the term bank partnership).

Although the specifics of the bank partnership model have evolved over time due to changing focus among federal and state regulators, the basic model places the nondepository lender as the "face" the borrower sees via an online lending platform (e.g., Kabbage, OnDeck, LendingClub, and many others). In a typical bank partnership model, the nondepository identifies a small business seeking financing and works with that business to determine how much money it is seeking and much it can qualify for. Although the small business is informed that the money it is borrowing is coming from the nondepository's bank partner, the bank's involvement occurs behind the scenes; the bulk of the interactions occur between the small business and the nondepository via the nondepository's branded online lending platform. A few days to a few weeks after the financing is consummated by the bank, the nondepository buys the loan back from the bank, placing it back on its books or bundling it with other loans and securitizing it as a means to raise new capital. Because the source of the financing provided to the small business is a bank rather than a nondepository, the transaction is subject to banking laws rather than state nondepository lending laws like the CFL. Some examples of banks that partner with nondepositories using bank partnership models include Celtic Bank, WebBank, and MetaBank.

Disclosures and not licensing. This bill requires some entities currently subject to licensure in California and many more entities not currently subject to licensure in California to provide small business borrowers with a standardized set of disclosures those borrowers can use to compare financing options. By requiring small business borrowers to be given a standard set of disclosures, this bill's author hopes to provide small business owners with information they need to make good financing decisions, without creating unnecessary licensing burdens on the entities extending that financing.

However, the unique approach taken in this bill carries with it two key challenges: oversight and enforcement. Without a licensing, registration, or enrollment requirement, there is no regulator, and without a regulator, there are no regular examinations, nor any administrative enforcement mechanisms with which to sanction entities for failing to provide disclosures in accordance with the bill. When a bill such as this is silent on both its oversight and enforcement mechanisms, the default mechanism is the courts.

FISCAL EFFECT: Appropriation: No Fiscal Com.: No Local: No

SUPPORT: (Verified 5/10/18)

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Small Business Majority
One private individual

OPPOSITION: (Verified 5/10/18)

Commercial Finance Coalition
Electronic Transactions Association
Equipment Leasing Finance Association
Innovative Lending Platform Association

ARGUMENTS IN SUPPORT: Small Business Majority writes, "Alternative lending has the potential to spur growth and innovation in the small business community, but regulations are needed to ensure small business borrowers are protected from predatory lenders and that they have the information they need to make the best decision for their business. SB 1235 will extend important protections to small businesses by requiring financers to provide transparent lending terms before a loan is disbursed."

ARGUMENTS IN OPPOSITION: The Commercial Finance Coalition states that the annualized cost of capital "is an untested metric that poses many of the same issues as APR. The annualized cost of capital calculation fails to recognize the difference between a loan, which is absolutely repayable, and an accounts receivable purchase transaction. And because this disclosure is not consistently used in any other type of transactions, it is likely to further confuse small business owners and increase the risk of litigation."

Prepared by: Eileen Newhall / B. & F.I. /
5/11/18 9:31:41

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