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Department of Business Oversight, Legal Division
Mark Dyer, Regulations Coordinator
1515 K St. Suite 200
Sacramento, Ca 95814-4052

Jan. 9, 2019

Dear Mr. Dyer,

Thank you for your invitation to comment on the proposed rulemaking for the implementation of Senate Bill 1235.

I authored SB 1235 to provide small business borrowers in California clear and consistent truth-in-lending disclosures that will enable them to easily compare the offers available in today's rapidly evolving market and to make informed decisions about the financing that would work best for them.

With considerable input from fellow legislators, stakeholders and the Department, we fashioned a bill designed to cover all kinds of commercial financing, including traditional term loans, open-ended credit plans, merchant cash advances, lease-financing, factoring and asset-based lending.

The large bipartisan majorities that voted in favor of SB 1235 in both the Senate and Assembly were a reflection of a broad consensus that California should lead the nation in making this crucial information available to our state's small business borrowers.

The Legislature provided clear and specific direction about which lenders should be covered by the law, which should be exempt, and which items should be disclosed. At the same time, we delegated to the Department the task of designing the disclosure, choosing which annualized rate should be part of the disclosure, and providing guidance to lenders to make compliance as easy as possible.

I write today in response to your Invitation For Comments on the proposed rulemaking to implement SB 1235 (PRO 01-18). In this letter I will offer my broad thoughts on what form the disclosure should take, along with a proposed example, and respond to many of the specific questions included in your invitation.

Overview

It is important that the disclosure required by the bill be presented to borrowers as a discrete document and that this document be limited to only those items listed in the bill. While the department cannot and should not try to prohibit lenders from providing more information than required by SB 1235, any additional information lenders provide should be separate from the mandated disclosure. This will prevent lenders from mixing other items within the disclosure in a way that could mislead borrowers, or using a mountain of verbiage to hide the information the Legislature decided was crucial for borrowers to know.

Each disclosure should include the same DBO-approved short, clear explanations of each item being disclosed and a standard order for disclosing that information so that potential borrowers can understand the terms and compare one offer to another at a glance.

To illustrate this point I have attached an example of how I believe this disclosure could be presented.

Below I have also provided my views on many of the specific questions presented in the department's invitation for comments.

Definitions

Total Amount of Funds Provided: The principal loan amount, or the purchase price in a cash advance, less any fees paid to or retained by the provider or an affiliate of the provider for originating or processing the commercial financing transaction. For a commercial open-end credit plan, the principal loan amount should be the maximum amount of credit available for draw by the borrower under the commercial open-end credit plan.

Total dollar cost of financing: The difference between the total of payments and the total amount of funds provided, assuming all payments are made when required. The total of payments should include all unavoidable fees and charges, including, if applicable, any fees or charges due at the time financing is retired or paid in full. For a commercial open-end credit plan, the total of payments should include the total dollar costs to be charged to a borrower based on the maximum draw amount of credit available under the plan, assuming the borrower repays the loan according to its original payment schedule, plus all required periodic and non-periodic fees and charges that cannot be avoided by the borrower.

The term or estimated term: The term of the financing should be disclosed in total calendar days or total business days, with the department determining which should be used by all lenders to ensure consistency. If the term is more than one month, it should also be disclosed as the number of months plus the remaining number of days in a partial month.

The method, frequency and amount of payments: For commercial financing that has fixed, non-variable period payment amounts: this should include the frequency and amount of each payment. For commercial financing that has variable periodic payment amounts, this disclosure should include a description of the method by which payments are calculated, the frequency of those payments, and an estimate of those payments. For financing that employs daily or weekly payments, a monthly amount should also be disclosed for consistency and ease of comparison with other financing.

A description of pre-payment policies: A statement of whether there are any costs associated with prepayment, including a reference to the paragraph in the financing agreement that creates the contractual rights of the parties related to prepayment.

Total cost of financing, expressed as an annualized rate.

The requirement that lenders disclose an annualized rate was a crucial component of SB 1235 because without it, borrowers would find it almost impossible to compare different types of financing that have different amounts financed, term lengths and charges. The annualized rate is the "common denominator" that allows each of these products to be measured against one another.

As introduced, SB 1235 required that lenders disclose an Annual Percentage Rate as calculated using the Federal Truth in Lending Act and Regulation Z. The bill was later amended to require disclosure of a rate (Annualized Cost of Capital) that represented all of the costs of the financing as a percentage of the amount financed, expressed as an annual rate. The final version of the bill maintained the requirement that all financing covered by the bill disclose an annualized rate but delegated to the department the choice of which annualized rate to require.

The main difference between APR and ACC is that APR recognizes the time-value of money. ACC is simpler, but provides less information that would help the borrower make an informed decision.

I continue to believe, as I did when I introduced SB 1235, that the Annual Percentage Rate is the best option -- as long as the department can provide sufficient guidance for lenders who use an estimated term to calculate the APR. An APR or estimated APR is already familiar to borrowers and is used by lenders not subject to SB 1235, including federally and state chartered banks and personal credit card providers. Requiring APR would therefore make it easy for small business borrowers to compare the options available to them.

The biggest advantage of APR is that it best reflects the time-value of money, which is an important consideration whenever borrowing or investing funds. Consider two loans of $10,000 each and a cost to the borrower of $2,000. One comes with a single payment of $12,000 after 12 months. The other requires equal daily payments for 12 months. On the surface the loans might look similar. Both provide the same funds and cost the same amount, and both are paid in full after 12 months. But there's a very important difference. Under the first loan, the borrower is able to use of all the money for the full 12 months before the loan is due. Under the second loan, the borrower must repay part of the loan starting on the very first day and every day thereafter. After one month, the borrower would have lost the use of $1/12^{th}$ of the money loaned. After 6 months, half the money would be gone. Yet both the APR and the Annualized Cost of Capital on these very different transactions would yield the same annualized rate.

These identical rates obscure the fact that the first option is clearly the better deal. A loan allows a borrower to pay for the privilege of using someone else's money for a limited time. All other things being equal, the loan with the longer term is the better value, because the borrower has the use of the money for a longer time, at the same price.

This is why we included APR in the original version of the bill. However, while there was broad agreement in the Legislature that every form of financing covered by the bill should disclose an annualized rate, there was some controversy over which rate to require. Most of the concern, I believe, was due to questions about whether financers that employed an estimated term and used a daily payment schedule – such as a merchant cash advance -- could accurately disclose APR using the federal rules. We resolved part of this quandary in the bill by allowing these providers to disclose an estimated annualized rate based on an estimated term. But the APR calculation also must reflect the declining balance of the loan as each payment is made. Merchant cash advance providers argued that they cannot know the declining balance in advance because the daily payments are not based on a schedule or formula but are instead tied to each day's cash flow. I suggest you resolve this issue by allowing these providers to estimate the daily payment as the total amount of payments divided by the number of payments. Further, I suggest you require all lenders who make this calculation to use a use a standard number of payment days in a month so that there is consistency from one lender to the next.

Estimated term

In cases where an estimated term is disclosed, I believe the department should require lenders and providers of non-loan financing to disclose to the borrower the same estimates they use in their own underwriting for that transaction. For a merchant cash advance, for example, the provider typically reviews the recipient's recent and seasonal cash flow and uses that data to develop an estimate of the merchant's future cash flow. The lender then multiplies that estimate by the percentage that will be withdrawn from the merchant's daily receipts and determines an estimated number of days it would take the recipient to repay the financing. Those same estimates should be disclosed to the borrower and used to calculate the estimated annualized rate.

The customer should be told that this is an estimated term based on their reported and estimated cash flow and that the actual term will vary if their actual cash flow is different. As long as these estimates are made in good faith and based on information provided by the borrower and verified by the lender, I believe this method will insulate lenders from any criticism (or litigation) stemming from the difference between the estimated and actual term.

Fees and charges to be included

The fees and charges included in the annualized rate calculation should include all fees and charges that cannot be avoided by the borrower. This would include but not be limited to service fees, interest, and any charges due at the time the financing is completely repaid.

Factoring and asset-based lending

SB 1235 provided the option of an alternative disclosure for factoring and asset-based lending when the lender offers a master agreement upon which future lending will be based. In these cases the lender may provide a disclosure based on an example amount drawn against this master agreement. It was my intent in authoring this provision that the department determine and require a specific and consistent amount that would be used by all lenders in calculating their example. In other words, all lenders could be required to calculate the costs of their financing based on every $1,000 borrowed, or whichever amount the department determines makes it easiest for borrowers to compare offers from different lenders. This is a crucial point, because if each lender uses a different number for their example it will be very difficult for borrowers to compare their offers. The term lengths and charges involved will vary and will produce different costs. If these costs are measured against a consistent example amount, borrowers will find it easier to shop for the best deal.

Pre-payment policies.

It is important that the disclosure of pre-payment policies include the fact that certain types of financing require the payment of all projected charges even if the financing is repaid early. In a five-year term loan, for example, a borrower who pre-pays the loan after three years need not pay interest on the money for the two remaining years of the contract. But in forms of financing that apply charges rather than interest, it is common practice to require all of those charges to be paid no matter when the borrower repays all of the amount financed. When this is the case it should be clear to the customer.

Thank you again for inviting me and other interested parties to comment in advance of your preparation of the draft regulations. I hope that this process will allow you to more easily resolve conflicts among the stakeholders. I would also note, however, that many issues were raised and resolved during the legislative process, and I encourage you to avoid re-deliberating those matters. Our small business borrowers need these protections now and I would like to see the regulations in place as soon as possible.

Sincerely,

Steve Glazer

Steve Glazer
Senator, 7th District