ELECTRONIC TRANSACTIONS ASSOCIATION

1620 L Street NW, Suite 1020
Washington, DC 20036

202.828.2635
electran.org

October 12, 2018

Senator Nellie Pou
Chair
Senate Commerce Committee
State House
Trenton, NJ 08625

RE: Opposed Unless Amended – SB 2262 (Commercial Lending Disclosure)

Dear Chair Pou:

On behalf of the Electronic Transactions Association ("ETA"), we appreciate the opportunity to share our thoughts regarding SB 2262. ETA supports transparency in small business financing disclosures, including providing borrowers with the best information to compare costs and make informed decisions. The competitive marketplace for small business lending dictates that transparency be front of mind for all parties in the relationship. ETA believes that this is best left to the competitive marketplace and opposes this bill as written. However, if the committee believes legislation is necessary in this space, we have a few thoughts on how that legislation should be modeled including a principles-based approach which provides a roadmap for both transparency and flexibility.

ETA is the leading trade association for the payments industry, representing over 500 companies that offer electronic transaction processing products and services, including financial institutions, transaction processors, payments networks, and others. ETA also has members that are engaged in online lending for commercial enterprises, primarily small businesses, either directly or in partnership with other lenders.

Small Business Lending Is Different Than Consumer Lending

It is imperative that this bill not conflate consumer lending with small business lending. Commercial and consumer credit are distinctly different types of credit. Small business borrowers have different needs and objectives in obtaining credit than consumers – often relying on financing to buy inventory, smooth cashflow, and expand their marketing. Small businesses are the backbone of the economy and providing them with that financing enables them to continue to grow. Small business lenders have developed credit products specifically designed to answer those needs and objectives. For example, the length of a small business loan is often measured in months rather than years. ETA cautions that a legislative approach that would simply apply existing requirements for consumer lending to small business loans would have detrimental effects for both online small business lenders and the small business community. Particularly, because ETA member small business lenders are providing access to credit to businesses that are traditionally underserved and unable to access financing through more conventional means.

Many of ETA's members provide loans to their customers that average less than $25,000. Small businesses often are looking for small amounts to get them through a period of time (i.e., to cover payroll) or to fund a specific activity (i.e., a new marketing campaign). ETA supports a system that provides small business borrowers with clear information on their rights and responsibilities.

While ETA supports transparency in small business credit, we encourage the Committee to be sensitive to the prospect that enhanced regulation may limit lenders' ability to answer such needs by stifling creativity and innovation. For these reasons, ETA encourages the committee to avoid conflating consumer lending with small business lending.

Principles-Based Approach Solely for Commercial Loan Products
Here are commercial loan disclosure principles that we believe could provide small business finance companies a uniform set of principles to guide transparency and disclosure when looking for a commercial loan product.

(a) Any entity making a commercial loan shall provide to the borrower a written statement showing in clear and conspicuous terms all of the following, as applicable, with respect to that commercial loan:

(1) Commercial Loan Costs.

(A) For a commercial loan not under an open-end credit program, commercial loan costs shall include, as applicable, the total dollar costs to be charged to a borrower, assuming the borrower pays the commercial loan according to its original payment schedule, plus all required fees and charges that cannot be avoided by the borrower.

(B) For a commercial loan under an open-end credit program, commercial loan costs shall include, as applicable, the total dollar costs to be charged to a borrower, based on the amount scheduled to be drawn by borrower at the time of disclosure, or if no initial draw is scheduled then the maximum draw amount of credit available under the open-end credit program, in each case assuming the borrower repays the commercial loan according to its original payment schedule, plus all required periodic and non-periodic fees and charges that cannot be avoided by a borrower.

(2) Commercial Loan Amount.

(A) For a commercial loan not under an open-end credit program, the principal loan amount of the commercial loan and, if different from the principal loan amount, the total amount disbursed to the borrower or at the borrower's direction, as applicable, after deducting any fees and charges that will be withheld from loan proceeds.

(B) For a commercial loan under an open-end credit program, the maximum amount of credit available for draw by the borrower under the open-end credit program and, if applicable, the amount scheduled to be drawn by the borrower at the time of disclosure.

(3) A description of the terms of repayment, including for a commercial loan not under an open-end credit program, the amount, number and frequency of any scheduled payments, as applicable.

(4) If applicable, the fact that a lender has acquired or will acquire a security interest in collateral and a description of the collateral.

(5) A description of any other fees in connection with the commercial loan that can be avoided by a borrower, including late payment fees and returned payment fees.

(b) The statement required by this section shall be provided to the borrower prior to execution of the commercial loan agreement, either as a separate disclosure or as part of the commercial loan agreement.

Specific Recommendations

In addition to the principles above, here are some more specific recommendations based on the legislation.

Small Business Loan Threshold

Section 1(a) – The bill should remove the $100,000 threshold.

The threshold of $100,000 is arbitrary and there is no policy justification to treat similarly situated providers differently based on loan size.

"Provides" A Small Business Loan

Section 1(a) – The small business lending threshold needs to be clarified.

Applying this threshold to a bank or entity that "provides" a small business loan will be confusing. For those loans that are provided through a traditional bank partnership arrangement, would that be considered "provided"? What about white label arrangement where a financial institution finds, and makes a loan, but a lending platform is used only as a technology vendor for the bank? Would a broker of commercial financings be deemed to "provide" commercial financings? If so, how would the broker be able to ensure that the disclosure is included since they do not control the loan agreement, underwriting or pricing processes? There needs to be additional clarity on this point, otherwise the bill threatens to create overlapping disclosures for multiple entities on a given loan.

Annual Percentage Rate and Interest Rate

Section 1(a)(1) and (2) – The Annual Percentage Rate and Interest Rate should be removed.

If an APR or interest rate disclosure was required for commercial financing, such a disclosure has the potential to be even more confusing and less useful for small businesses for many reasons, including the following:

a. Mandating the calculation of APR in a commercial setting would result in different calculations depending on the product, even if the overall repayment amount is the same. For example, APR does not contemplate daily pay loans. How would weekend and bank holidays be addressed? Some lenders skip those days and others require make up payments. If lenders address these issues differently, it will result in different APRs for the exact same product, even when the total dollar cost of credit is the same. There is no benefit to a small business by imposing an APR disclosure on a product that was never contemplated to be covered and that would result in misleading APRs.

b. The Bill does not specify exactly how the APR should be disclosed. TILA specifically mandates that the APR disclosure be accurate with 1/8 of 1 percentage point. 12 C.F.R. 1026.22(a)(2). This requires the APR to be disclosed at least to one decimal point in many circumstances.

c. The Bill does not address any tolerance limits for APR calculation errors. As mentioned in paragraph b above, TILA has specific rules for APR calculation errors and provides a threshold in which an APR is deemed accurate. However, an APR that falls above that threshold is a violation of TILA.

d. Under TILA, an APR cannot be calculated without a determination as to what types of fees and charges are Finance Charges (a defined term under TILA). Finance charges are included in the APR calculation. Therefore, in order to calculate APR there must be clear guidance on what is or is not a Finance Charge. The proposed Bill does not state what fees should be considered Finance Charges.

e. APR calculations are highly duration-sensitive for loan terms of less than a year. In other words, the APR increases rapidly the shorter the loan term. For example, the APR of typical short-term commercial loans will fluctuate widely based on only small differences in the term of the loans.

f. Total Cost of Capital ("TCC") is more useful for comparing the absolute cost of commercial financing with a small business's expected return from investing the financing proceeds. A business that expects a short-term return on its investment would likely choose a financing product with a shorter term and higher daily, weekly or monthly payments to minimize TCC, even though that financing product is likely to have a higher APR.

g. Similarly, certain commercial finance products, such as the purchasing of future account receivables have a fixed cost but no fixed term and are paid through a set percentage of the small business' future account receivables.

h. Currently, the Federal Government nor any state has mandated or applied an APR disclosure to the purchasing of account receivables because there is no fixed repayment term, most models do not include fixed daily payments, and there is no absolute right to repay.

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The clearest cost disclosure is the dollar cost of credit or total cost of capital, which is what matters to small business owners, and what most of the industry is already providing and what the industry should be providing across all products. Total cost is readily calculable and provides the clearest basis for comparison among commercial finance options, no matter how they are denominated (loan, purchasing of future receivables, factoring, equipment lease).

Third Party Agreements

Section 1(a)(7) – This component should be deleted.

This section is confusing and is unclear as to what third party agreements would be required to be disclosed. Additionally, descriptions of relationships with third parties and fees paid under those agreements can in some cases be proprietary information. It is also unclear as to what would constitute a conflict of interest under this bill.

Overview of Online Small Business Financing Models

Many online small business lenders share a number of similarities that include:

- Providing borrowers with efficient access to credit that relies on existing data streams and automation, rather than a lengthy form process, often providing funding decisions within 24 to 72 hours and in certain instances, in as few as 7 minutes.
- Offering small loans with short-term maturities, between 6-18 months, although some up to 36 months.
- Using automated online loan applications (either with data they already have from the customer or data that the customer provides them) and have no retail branches.
- Utilizing electronic data sources and technology-enabled underwriting models to automate processes such as determining a borrower's identity or credit risk. The data sources used include traditional underwriting inputs, but also real-time business accounting, payment and sales history, online small business customer reviews, and other non-traditional or alternative data.[1]

While online small business lenders have many different types of business models, two major business models have emerged.

The first type of primary business model for online small business lenders is as a direct lender and, where applicable, as a state licensed lender in those states requiring licenses. In such states, direct lenders originate loans and may be required to obtain licenses or register with the individual states in which they lend. These direct lenders do not rely on depository institutions to originate loans, but rather make loans themselves and either hold those loans in their own portfolios or rely on capital sources including credit facilities, whole loan sales, and securitizations to fund their originations.

[1] *See* U.S. Department of Treasury, *Opportunities and Challenges in Online Marketplace Lending*, p.5 (May 10, 2016).

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The second type of primary business model for online small business lenders is the bank partnership or lending platform model. Lending platforms provide services for an issuing depository institution to process loans and then purchase the loans to hold on their books or for sale to investors as whole loans or by issuing securities such as member-dependent notes. In this model, the issuing depository institution originates loans to borrowers that apply on the online platform. The loans are subsequently held by the issuing depository institution for a period of time (typically 1-21 days) and then purchased by the lending platform or directly by an investor through the platform.

Under this model, lending platforms are not the lender because they do not originate the loans. Rather lending platforms are technology or outsource vendors rather than the actual lender. The issuing depository institution is expected by its banking regulator to oversee the lending platform as a vendor. An online lending platform that meets the statutory definition of a bank service company or a third-party service provider to one or more depository institutions may also be subject to the regulation and examination authority of the relevant federal banking agencies under the Bank Service Company Act.[2]

As the market develops, both direct lenders and lending platforms are altering these frameworks to allow more flexibility to provide credit to small businesses. Some direct lenders have developed hybrid models, selling some whole loans to institutional investors while retaining servicing responsibilities. The combination of data-driven underwriting, automated and online operations, a lack of legacy systems, and investor capital has allowed online small business lenders to make third-party arrangements to fill a need in the small business lending market.

Overview of Online Small Business Financing Products

The small business financing market has a number of participants who help to provide small businesses with access to funding by matching them with lenders or by providing a variety of financing options and products that range from fixed term loans, open-ended lines of credit, and the purchase of future accounts receivables.

<u>Referral Partners</u>

Referral partners may perform a variety of services, including assisting borrowers to identify potential financing options, generating leads for lenders, and in some cases, assisting in the application process. There are a few types of referral partner business models in the market today, but the common thread among referral partners is that they do not make credit decisions on credit applications.

One prominent referral partner model is the marketplace matchmaking platform model. Marketplace platforms provide a portal where small businesses can go to use the resources and partnerships of the referral partner to help small businesses with certain aspects of getting commercial financing. In many cases, the small business fills out (or at times, the company pre-

[2] 12 U.S.C. §§ 1861-1867.

fills on the small business's behalf by using data from their financial management software) an application and is given a choice of tailored financing available from a variety of financiers. The credit decisions and financing are made by independent, third party financiers including traditional lenders, online lenders, companies that purchase future receivables and SBA-approved lenders. Those participating financiers may offer term loans, SBA loans, lines of credit, purchasing of future account receivables, invoice financing and small business credit cards. The criteria are established by the participating financier on the platform to give a small business a clear understanding of the range of financing options available to them. The small business chooses its preferred choice of financing product and financier and the platform forwards the application information to the financier. The financier makes the credit decision on the application.

Marketplace platforms often serve as highly valuable price and product comparison tools for small businesses. Marketplace platforms play a key role in helping to match small businesses and their individual credit needs to financier that can provide products which meet those credit needs.

Purchase of Future Account Receivables

The purchasing of future account receivables are not loans, but rather, they are a sale of a portion of the small businesses' future credit and/or debit card receivables. Companies that provide funds to businesses in exchange for purchasing a percentage of the businesses' daily credit card income, those funds come directly from the processor that clears and settles the credit card payment. A company's remittances are drawn from customers' debit and credit-card purchases on a daily basis until the obligation has been met. Many purchasers form partnerships with payment processors and take a percentage of a merchant's future credit card sales. Purchasers offer an alternative to businesses who may not qualify for a conventional commercial loan and provide flexibility for merchants to manage their cash flow by fluctuating with the merchant's credit and/or debit card sales volume.

The distinguishing characteristic of a purchase of account receivables is that there is no fixed scheduled payment amount or term. When the merchant makes a sale via credit and/or debit card, a percentage of the transaction is forwarded to the purchaser. This continues until the total amount of purchased receivables has been paid. The MCA provider receives the purchased receivables in one of the following ways: (i) the merchant's processor forwards the purchased receivables directly to the funder; (ii) the merchant's receivables are deposited into a lockbox account that forwards the purchased receivables to the provider and remits the balance to the merchant; or (iii) the provider is notified of the amount of the credit card receivables generated and the funder debits the purchased portion from the merchant's bank account.

For many small businesses, the purchase of future account receivables is an alternative to a traditional commercial loan because the transaction does not require personal guarantees from the business owner only a performance guaranty. The performance guaranty requires that the owner ensure that the business entity complies with all of the terms and conditions of the purchasing agreement. Moreover, unlike a commercial loan which has an absolute right to repay, in the event a business closes, and does not breach the agreement, the business is not held responsible to pay the remaining balance on the agreement. The purchaser takes a risk that a business may close.

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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.

Sincerely,

PJ Hoffman

PJ Hoffman
Director of Regulatory Affairs
Electronic Transactions Association
PJHoffman@electran.org
(202) 677-7417

Cc: Members of the Senate Commerce Committee
Senator Troy Singleton