



paypal.com

October 28, 2020

Manuel P. Alvarez, Commissioner
California Department of Financial Protection and Innovation
1515 K Street, Suite 200
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Via Electronic Mail To: Charles Carriere, Senior Counsel [REDACTED]@dbo.ca.gov
With A Copy To: Jesse Mattson, Senior Counsel [REDACTED]@dbo.ca.gov

RE: FILE NO. PRO 01-18
RESPONSE TO PROPOSED REGULATIONS - COMMERCIAL FINANCING DISCLOSURES
(PRO 01-18)

Dear Commissioner Alvarez and Mr. Carriere,

PayPal, Inc. ("PayPal") is pleased to offer comments in response to the proposed regulations implementing California Financial Code Sections 22800 through 22805, which require disclosures in small business financing. PayPal recognizes the importance of providing clear disclosures which are both meaningful and accurate. However, there are several key areas of concern with the proposed regulations. As outlined below, we respectfully request that these concerns be addressed before the Department's regulations are finalized.

I. BACKGROUND

PayPal is a leading online payments company, with over 345 million active user accounts globally. PayPal is also a general servicer and marketing servicer, through an arrangement with WebBank, an FDIC insured state-chartered bank, for three small business lending products: PayPal Working Capital (PPWC), PayPal Business Loan (PPBL), and LoanBuilder, A PayPal Service (LBAPS). In 2019 alone, these three products provided over \$772 million in financing to more than 18,000 California small businesses. Additionally, PayPal, in conjunction with WebBank, participated in the SBA's Paycheck Protection Program (PPP), nationally facilitating approximately \$2.1 billion in loans for approximately 76,000 small businesses, and in California specifically, more than 16,000 loans, equating to approximately \$564 million, with an average loan size of approximately \$34,900.

These business financing products serviced by PayPal are unique and transparent products that provide fast, flexible, and fair access to credit for small businesses that otherwise may not receive funding. The PPWC product offering is primarily based on a business' PayPal account history and is structured to be repaid through a chosen percentage of the business' PayPal sales, with a minimum payment required every 90 days. The PPWC application and funding can take just minutes. The PPBL and LBAPS product offerings are short, fixed-term loans, ranging from 13-52 weeks, with fixed weekly

payments. For PPBL and LBAPS, small businesses will typically receive funding within 24-48 hours of approval. The cost for all these loan products is structured as a single, fixed fee that the borrower knows in advance, without any periodic interest charges, late fees, or prepayment fees.

PayPal has done extensive research on these lending products and the benefits they provide to small businesses, particularly those in underserved and minority communities. In our recent report, *Alternative SMB Financing: Fueling Underserved Entrepreneurs*,¹ among the key findings were the following:

- 70% of PPWC loans were made to borrowers in the 10% of counties that lost 10 or more bank branches since the 2008 financial crisis. Also, the share of total PPWC being distributed to borrowers in so called “Banking Deserts” is 2x the share of traditional SMB loans.
- 26% of PPWC loans were made to borrowers in low-moderate income census tracts, compared to 22% for traditional SMB loans. These same low-moderate income census tract businesses exhibited better growth rates with PPWC. For example, in 2017, the YOY growth rate for these borrowers was 22% vs. the average SMB growth rate of 9%.
- The percentage of total PPWC loans made to female-owned businesses is 33%, while only 16% of conventional small business loan recipients are female.

Additionally, PayPal regularly conducts surveys of our small business borrowers to ensure we continue to offer services that meet their needs. From data gathered in 2019, overall, the level of satisfaction with processes and products for PPWC and PPBL is favorable – more than 85% of respondents in almost all satisfaction categories selected a positive or very positive rating.

According to borrowers surveyed in October 2019, 95% of PPBL borrowers surveyed gave a positive or very positive rating to the loan's ease of application, and 94% gave a positive or very positive rating to the time it takes to apply and receive funding. For borrowers surveyed about PayPal Working Capital in April 2019, 99% of PPWC borrowers surveyed gave a positive or very positive rating to the time it takes to apply and receive funding, and 85% gave a positive or very positive rating to the loan's repayment flexibility. These results demonstrate that the business financing products serviced by PayPal are unique and transparent products. While PayPal fully supports transparency, it cautions against prescribing regulations that may confuse applicants, impede the ease of application, and be counter to the goals of providing helpful information to small businesses.

II. CHANGES TO PROPOSED REGULATIONS

In order to preserve the tenets of fast, flexible, and fair financing, which are essential to today's small business owners, disclosures should be both meaningful and helpful to borrowers. As such, PayPal respectfully recommends the following changes to the Department's proposed regulations.

¹ The study is based on PayPal data analyzing PPWC, PPBL and LBAPS loans disbursed to businesses in the U.S. between October 2014 to September 2018. See https://publicpolicy.paypal-corp.com/sites/default/files/policy/Alternative_SMB_Financing_Fueling_Underserved_Entrepreneurs.pdf.

A. Effective Date of Regulations

PayPal prides itself on its high standards and excellent customer experiences for its users. The additional disclosures contemplated by the proposed regulations require significant programming work and technical systems changes, including user experience changes and redefining aspects of the products' underwriting processes, strategies and technical rules.

As a result, the changes in the proposed regulations means allocating significant time and resources to ensure compliance with the proposed regulations does not degrade customer experiences. Specifically, this high level of effort requires significant research, design, and development time plus time for appropriate testing and monitoring. As such, a more reasonable and realistic compliance timeframe is 18 months. If the Department cannot accommodate an 18-month compliance timeframe, at a minimum, the timeframe should be extended to 12 months.

B. Application to California Businesses

The proposed rules provide that the requirements of Section 22802, subdivision (a) apply "only to recipients whose business is principally directed or managed from California." However, the Department does not set forth how that should be determined. To provide clarity to both providers and recipients, the proposed rules should include that a provider can assume a business is "principally directed or managed" from California based on the business address of the applicant provided in an application for financing.

C. Explanatory Language For Term and Annual Percentage Rate

While the proposed regulations include certain explanatory disclosures for term and APR, these explanatory disclosures do not make clear that (1) while shorter-term loans will reflect a higher APR, that APR may not be indicative of the true cost of credit, and (2) where estimates are required, the actual term or APR may vary from the disclosure estimate depending on actual time to repay.

APR as a metric can be confusing. This is especially true because APRs for shorter-term loans – like PPWC, PPBL, and LBAPS – will be higher than APRs for loans with longer terms, even though the actual cost of financing could be significantly higher with a longer-term loan.

To help small business borrowers understand the metrics provided and accurately compare financing options, the regulations should allow a provider to include disclosures explaining the disclosed Term / estimated Term and APR / estimated APR in the context of the structure of the particular credit product. Specifically, the regulations should allow a provider to include a disclosure that explains that, while shorter-term loans may show a higher APR or estimated APR, that should be viewed in the context of the overall cost of credit, rather than in isolation. Additionally, where estimated Term and estimated APR are shown, the regulations should also allow an explanation that estimated term and APR are estimates that may vary depending on actual time to repay.

D. Tolerances

The proposed regulations state that APR should be determined in accordance with Regulation Z, see §3001. However, the proposed regulations only include one of Regulation Z's three key concepts

related to disclosure accuracy. Specifically, in addition to the numerical accuracy tolerance of “1/8 of 1 percentage point above or below the annual percentage rate” included in Section 3001, the regulations should also include two other key tolerances of Regulation Z: (1) that a provider that has made an inaccurate disclosure may “cure” any violation resulting from such disclosure if, within 60 days of discovery and before any action is instituted against the provider for such violation, the provider notifies the borrower of the inaccuracy and makes any correction necessary to assure that the borrower will not be required to pay an amount in excess of the charge actually disclosed, and (2) that there is no liability if a provider can show that a violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error. See 15 U.S.C. §§ 1640(b) and (c).

If these liability-limiting concepts are reasonable as applied to consumer transactions, they are even more so as applied to commercial transactions. The Department should incorporate these additional two concepts into the proposed regulations, while being cognizant of the fact that the tolerance ranges under Regulation Z were adopted for consumer loans, and as such, more liberal tolerances should be available for small business loans. Additionally, there should be no tolerance limit for inadvertent over disclosures (e.g., disclosing an annualized rate as 36% instead of 35%). A provider would never purposefully overstate the costs of its product and, in the event it inadvertently did so, the overstated information is not likely to lead to borrower harm because the business would pay less than expected in interest and fees.

E. Closed-End Financing Explanatory Disclosures

The Department has prescribed disclosures with specific explanatory language for various types of financing transactions. As set forth below, PayPal respectfully requests the Department modify its proposed regulations with respect to certain disclosures for closed-end transactions.

i. “Funding You Will Receive” Explanatory Disclosure

Section 2061(a)(2) requires a provider disclose the “Funding You Will Receive,” to a recipient, which is the “amount of funds that will be provided to the recipient, excluding any deductions such as origination charges and *amounts used to pay off other financings.*” (emphasis added). Because payoff amounts for prior credit can change up through the day of funding the new financing, the amount disclosed as the “Funding You Will receive” may also change up through the day of funding. As such, when a payoff of prior credit is involved, a disclosure that is accurate at the time it is shown to the recipient may no longer be accurate at the time of funding. To account for this, the Department should allow additional, optional explanatory language to make the recipient aware of this potential change. This also applies to other types of financing where “Funding You Will Receive” is a required disclosure.

ii. “Annual Percentage Rate” Explanatory Disclosure

It is unclear which Annual Percentage Rate (“APR”) disclosure would apply to products like PPBL and LBAPS, where the only cost for the loan is a single fixed fee that the borrower knows in advance, and the fixed fee is not based on interest accrued.

While Section 2061(a)(3) sets forth different explanatory disclosures for APR depending on the type of rate or fee, for PPBL and LBAPS, it appears that two disclosures may apply. However, as noted in the bold text below, these disclosures are inconsistent with one another:

- If the contract provides for a *single, fixed interest rate*: “APR is the cost of your financing expressed as a yearly rate. APR includes the amount and timing of the funding you receive, interest and fees you pay and the payments you make. APR is not an interest rate. **Your interest rate is [interest rate]**. Your APR may be higher than your interest rate because APR incorporates interest costs and other finance charges.” (emphasis added).
- The following language, *if no part of the finance charge is based upon interest accrued*: “APR is the cost of your financing expressed as a yearly rate. APR includes the amount and timing of the funding you receive, fees you pay and the payments you make. Your APR is not an interest rate, and **your loan does not have an interest rate.**” (emphasis added).

To remedy this inconsistency, the Department should clarify that, where the financing includes a single, fixed fee that is not based on accrued interest, the only disclosure required is the second disclosure for financing where “no part of the finance charge is based upon interest accrued.”

iii. “Term” Explanatory Disclosure

Section 2061(a)(6)(C) states that, after providing the term of the transaction, the provider must include “an explanation describing the term.” PayPal asks the Department to (1) clarify precisely what this requires and how this explanation may be different than the term shown in the second column of the proposed disclosure table, and (2) consider whether it should even be required given the term disclosure in that second column.

F. Sales-Based Financing Disclosures

As noted above, the PPWC loan product allows borrowers to repay with a percentage of each PayPal sale, with a minimum payment required every 90 days. This allows borrowers significant flexibility and is an important alternative to traditional, term-loan financing. Because of its structure, PPWC does not have a fixed duration or term, though an estimated loan duration is shown to businesses when they apply.

While the proposed regulations do account for certain sales-based financing products, several of the proposed regulations do not account for the nuances of a product like PPWC and are not appropriate in the context of the PPWC product construct.²

² This may be because the Department views sales-based financing as a subset of asset-based lending transactions. See Initial Statement of Reasons, PRO 01/10, Page 34 (“Sales-based financing transactions, which are a subset of asset-based lending transactions . . .”). However, the proposed regulations for sales-based financing also state that the requirements apply to all sales-based financing . . . “*except for asset-based lending that meets the definition of sales-based financing*” § 2065(a). So, while it seems the Department may recognize that not all sales-based financing is asset-based lending, the distinctions are not sufficiently addressed, and the assumptions about asset-based lending should not be imposed on all sales-based financing.

i. Estimates For Sales-Based Financing

Because PPWC does not have a fixed term or payments, the disclosures for PPWC must, by virtue of that product structure, be based on estimates. The proposed regulations include two sections setting forth how estimates can be determined: (1) the “Historical Method,” which uses historical average sales volume, or (2) the “Underwriting Method,” which allows providers to use “internal estimated sales, income, or receipts projection.” See §§ 2091, 2092.

As a threshold matter, the titles of both Sections specify that they are for “Accounts Receivable Purchase Transactions,” but the text of the proposed regulations for both sections states “[t]his section shall apply only to sales-based financing.” See §§ 2091, 2092. The Department should clarify whether the “Estimates” provisions in Sections 2091 and 2092 apply to sales-based financing like PPWC.

Historical Method: PPWC uses annualized historical sales data to estimate loan duration and repayment. The proposed rules for the Historical Method are too rigid for loans like PPWC and should be changed to allow for more flexibility. Specifically, the proposed regulations limit flexibility by requiring providers to:

- “fix the number of months considered to determine the recipient’s average monthly historical sales or income, provided that *the period of historical data used by the provider shall not be less than four (4) months or more than twelve (12) months.*” § 2091(a)(2) (emphasis added).
- “use the same number of months to determine *all recipients’* average historical sales or income, except where a recipient has not been in operation for the number of months set by the provider.” § 2091(a)(3) (emphasis added).

If applied to loans like PPWC, these two provisions will constrain providers’ ability to provide flexible financing solutions, like PPWC, to the detriment of small business borrowers.

First, requiring the same number of months to determine all recipients’ historical sales or income, unless the recipient has not been in operation for the set number of months, incorrectly assumes that small business borrowers have and will be able to provide historical information about income sourced from different payment channels. For example, a small business may have been in operation for several years, but only just started processing payments through PayPal three months ago.

Second, there may be instances where a small business has an outlier month which a provider should be able to exclude from its analysis. For example, a small business may have monthly sales of \$20,000, but then has a month with \$1,000 in sales, due to, for example, a natural disaster. As proposed, the Historical Method does not allow flexibility to remove that outlier month.

Third, the proposed regulations do not account for the fact that a provider may use different historical periods for different types of loans or different loan sizes. Requiring a provider to use the same number of months in evaluating each recipient does not allow providers the necessary flexibility.

If the Department's position is that Sections 2091 and 2092 apply to all sales-based financing, the Department should remove the two requirements set forth in Sections 2091(a)(2) and (3) above and should not require a fixed number of months in conducting a historical analysis. At the very least, this language should be clarified to state that, where a recipient does not provide information for the fixed number of months or information is otherwise inconsistent or not indicative of sales trends, the provider may calculate the historical sales volume with respect to a particular payment channel or mechanism using an average from the months for which the recipient has provided information and which the provider deems consistent with or indicative of sales trends.

Underwriting Method. As an alternative to the Historical Method, the proposed regulations allow a provider to calculate the disclosures "using an 'internal estimated sales, income, or receipts projection' through the particular payment channel or mechanism designated in the contract" which "shall be calculated using the best information reasonably available to the provider." §§ 2092(a)(2) and (3). While this allows providers flexibility, it requires a self-audit every four months. The frequency of the required audit is a burdensome requirement, and PayPal respectfully recommends that it be changed to an annual audit requirement, with a 10% threshold for the "audited APR spread," which is defined in Section 2092(a)(4)(D) as the median APR spread for all sales-based financings in the audit. If the audited APR spread is above 10%, then more frequent audits can be required, and a provider can work with the Department to refine the provider's methodology.

ii. "Estimated Annual Percentage Rate" Explanatory Disclosure

The proposed rules include an estimated APR disclosure for sales-based financing. As part of that requirement, Section 2065(a)(3)(C) states that a provider must include the following explanation "APR is the estimated cost of your financing expressed as a yearly rate. APR incorporates the amount and timing of the funding you receive, fees you pay, and the periodic payments you make. *This calculation assumes your estimated monthly income through [description of particular payment channel or mechanism] will be [monthly income estimate determined in accordance with sections 2091 or 2092 of these rules].*" (emphasis added).

It is unclear what is sufficient to satisfy the requirement to provide a "description of particular payment channel / mechanism." The Department should clarify that this does not require a provider to list each source of income analyzed, but instead, a provider can state "the income information you provided" or, for example, in the case of PPWC, the information provided through "your PayPal account."

iii. "Estimated Payment" Explanatory Disclosure

The proposed explanatory disclosure for estimated payment should be revised so providers are not required to provide a list of varying payments based on anticipated changes in income. The proposed regulations require "[i]f the provider anticipates that the periodic payment amount will vary over the term of the transaction, the provider shall list all periodic payment amounts and the time periods when those payments apply. For example: Months 1-2: \$20/day; Months 3-7: \$40/day." § 2065(a)(5).

PPWC provides flexibility for its small business borrowers by allowing varying payments based on when a borrower has sales through PayPal. PPWC does not predict specific days when the borrower will/will not have sales. However, as drafted, the regulation could be read to require this disclosure

to be made in the context of a PPWC-like product construct, where the ability to provide such a disclosure is inherently impossible, and where any such disclosure would neither be helpful nor meaningful for small business borrowers. Instead, the Department should remove the statement requiring a provider to list varying payments based on an anticipated change in income, and instead, only require it if payments change based on specific contractual reasons.

G. Signatures on Disclosures

The proposed rules should clarify that an “electronic signature” includes any assent by an applicant that satisfies requirements for applicable federal and state laws governing electronic signatures.

H. Timing for Presentment of Required Disclosures

Section 22802 of the California Financial Code requires disclosures be provided “[a]t the time of extending a specific commercial financing offer.” The proposed regulations clarify that this means when “a specific amount, rate or price, in connection with a commercial financing, is quoted to a recipient, based upon information from, or about, the recipient” and “[a]ny subsequent time when the terms of an existing commercial financing contract are amended or supplemented, prior to the recipient agreeing to the changes, if the resulting changes to the contract would result in an increase to the finance charge, payments, term, or annual percentage rate, regardless of whether those terms were previously disclosed to the recipient.” § 2057(a)(4).

This proposed regulation does not account for phone applications, when general terms, including amount and price, may be presented to a recipient, and where a written presentation of all terms and required disclosures is provided before the applicant accepts the loan. Providing such disclosures at the outset of phone-based applications could cause delay and confusion for recipients. To remedy this, the regulations should state that the disclosure requirements apply when a formal written offer is presented to a recipient and not to any discussions leading up to presentation of a formal offer.

* * * *

Thank you for the opportunity to participate in the discussion on this important issue. PayPal would welcome an opportunity to meet with the Department to discuss the PPWC, PPBL and LBAPS products and the issues set forth in this letter.

Sincerely,

/s/

Bernardo Martinez
Vice President, Global Merchant Lending