manatt

Scott M. Pearson
Manatt, Phelps & Phillips, LLP
Direct Dial: [redacted]
E-mail: SPearson@manatt.com

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By E-Mail to regulations@dfpi.ca.gov and charles.carriere@dfpi.ca.gov

Commissioner Manuel P. Alvarez
California Department of Financial Protection and Innovation
2101 Arena Boulevard
Sacramento, California 95834

Re: PRO 01/18 – Commercial Financing Disclosures (SB 1235)

Dear Commissioner Alvarez:

We submit this letter on behalf of our client, the Small Business Finance Association ("SBFA"). SBFA is a non-profit advocacy organization dedicated to ensuring that Main Street small businesses have access to the capital they need to grow and strengthen the economy. SBFA's mission is to educate policymakers and regulators about the technology-driven platforms emerging in the small business lending market and how its member companies bridge the small business capital gap by offering innovative closed- and open-end loans, merchant cash advances ("MCAs"), equipment financing, and factoring. SBFA's members are committed to promoting small business owners' access to fair and responsible capital.

SBFA previously submitted comment letters to the Department on January 19, 2019 and September 9, 2019 in response to earlier invitations for comments. We appreciate the Department's thoughtful consideration of our prior comments, as well as this additional opportunity to provide our views on SB 1235 and the regulations proposed in the formal rulemaking that commenced on September 11, 2020 ("Proposed Regulations"). SBFA supports SB 1235's goal of allowing small businesses to compare the costs of various sources of financing. In order to achieve this goal, the regulations implementing SB 1235 should ensure that disclosures are meaningful and understandable for small businesses, and also feasible for capital providers.

Timing of Disclosures

Sections 22802 and 22803 of SB 1235 call for providers to make disclosures "at the time of extending a specific commercial financing offer to th[e] recipient," and to "obtain the recipient's signature on such a disclosure before consummating the commercial financing transaction." The information to be disclosed under the statute includes "[t]he total amount of funds provided," "[t]he total dollar cost of the financing," "[t]he term or estimated term," "[t]he method, frequency, and amount of payments," "[a] description of prepayment policies," and, except for certain types of financing, "[t]he total cost of the financing expressed as an annualized rate."

Under the federal Truth in Lending Act and Regulation Z, disclosures generally are required to be made "before consummation of the transaction." *See, e.g.*, 12 C.F.R. § 1026.17(b). This recognizes the reality that preliminary discussions regarding financing generally take place before the provider has done sufficient underwriting to make all of the required disclosures.

The Proposed Regulations, however, depart from this nationwide convention for consumer finance. Section 2057(a)(4) defines "at the specific time of extending a specific commercial financing offer" to mean "[t]he time when a specific amount, rate **<u>or</u>** price, in connection with a commercial financing, is quoted to a recipient, based upon information from, or about, the recipient," or at any subsequent time when the terms of an existing contract are amended or supplemented in a manner that would increase the "finance charge, payments, term, or annual percentage rate." Put differently, the Proposed Regulations would require providers to make all required disclosures as soon as one of three terms (amount, rate, or price) is "quoted."

SBFA respectfully submits that the trigger for disclosures should be changed because providers will not otherwise be able to comply. When small businesses commence discussions with providers or brokers regarding financing, it is very common to start with only one or two terms of particular interest to the business, often the amount of funds they need. Providers or brokers may often "quote" a financing amount, say $20,000, before the small business has submitted the information the provider needs to formulate a specific offer for this funding amount. Indeed, the information required for underwriting can vary based on the amount of funds being requested.

By making any "quote" of the loan amount, rate, or price the trigger for when a provider must make all of the required disclosures, the Proposed Regulations will make compliance impossible because the provider will not yet have determined all terms that are required to be disclosed. Accordingly, Section 2057(a)(4) should be changed to trigger the disclosure obligation when a "specific amount, term or estimated term, cost, <u>and</u> periodic payment amount" is quoted.

This alternative definition is necessary not only because it would allow providers to make the required disclosures, but also because it is consistent with the language of SB 1235 itself. Under the statute, the disclosure requirements are triggered only when a "<u>specific</u> commercial financing <u>offer</u>" is made. It is fundamental that an "offer" must be sufficiently definite and certain to allow the party receiving the offer to accept it and form a binding contract, and that a proposal with open or uncertain terms is not an offer. *See, e.g.*, B.E. Witkin, Summary of California Law, Contracts, § 137 (citing *Weddington Productions v. Flick*, 60 Cal. App. 4th 793, 811, 71 Cal. Rptr. 2d 265 (1998), and *Holmes v. Lerner*, 74 Cal. App. 4th 442, 457, 88 Cal. Rptr. 2d 130 (1999)); Restatement (2d) of Contracts § 33. Thus, when a provider or broker quotes only an amount of financing or a rate or price, it has not made a "specific offer" and no disclosure is required by SB 1235. The Proposed Regulations should be revised to require disclosures only when a complete offer has been formulated, consistent with the limited authority provided by the statute. *See* Cal. Gov't Code §§ 11349(b), 11349.1.

Consistent with the practice and expectations created by TILA and Regulation Z, the disclosures should be provided at the time a specific offer is made, i.e., when the financing agreement is presented to the recipient. The disclosure document should be required to precede the financing agreement when presented to the merchant, by placing it on top of the agreement and stapling them together or scanning them together so that the disclosure document is the page immediately prior to the agreement in the scanned agreement.

The Department Should Adopt ACC Rather Than APR to Disclose the Total Cost of Financing Expressed as an Annualized Rate

SB 1235 requires providers of commercial financing to disclose "the total cost of financing expressed as an annualized rate." Cal. Fin. Code § 22802(a)(6); Cal. Fin. Code § 22803(a)(6). The statute does not further define "annualized rate" but instead provides that the Department will adopt regulations on the "appropriate method to express the annualized rate disclosure and the types of fees and charges to be included in that calculation," as well as how the estimated annualized rate is to be calculated. Cal. Fin. Code § 22804(b). Notably, the author of SB 1235, Senator Glazer, supported an effort to improve the bill by specifically requiring disclosure of this annualized rate using the Annualized Cost of Capital ("ACC") metric rather than Annual Percentage Rate ("APR"). A version of the bill including this ACC metric was passed by the Senate, but the language relating to the ACC was replaced with the more generic "annualized rate" language in the Assembly.

Numerous commenters including SBFA previously urged the Department to adopt ACC rather than APR, arguing that APR is significantly more burdensome to calculate and disclose than ACC, and also less effective in achieving the purpose of SB 1235 and its implementing regulations, which is to allow commercial borrowers to understand and compare different financing options. Notwithstanding these arguments, the Proposed Regulations employ APR as the annualized rate. Moreover, the Initial Statement of Reasons accompanying the Proposed Regulations does not describe the ACC alternative or explain the Department's reasons for rejecting it. *See* Cal. Gov't Code § 11346.2(b)(4).

SBFA respectfully submits that ACC should be used instead of APR. While ACC is easy to calculate and verify, APR is extremely complex and not feasible for many widely used commercial financing products. Furthermore, ACC would help small businesses understand the cost of various financing options without creating harmful confusion.

A. APR Calculations Are Extremely Complex And Not Viable For Many Commercial Financing Products.

SBFA and other commenters, including PayPal and Rapid Advance in the first round of comments, previously have explained in detail why APR is a burdensome and confusing metric. For the Department's ease of reference, those explanations are summarized here.

APR is determined through a long series of calculations concerning the impact of each contemplated payment on the account balance and the amount of interest being paid over time, among other things. These calculations generally must be performed using specialized software because they are too complicated and burdensome to be done by hand or with a scientific calculator, and commonly available spreadsheet programs lack the capacity to perform them. The most commonly used software historically was the Office of the Comptroller of the Currency's APR WIN program, which recently was discontinued. APR WIN had significant limitations, as it was designed for the most common consumer loans with monthly payments in mostly uniform amounts. In particular, the program is not designed to handle daily or weekly payments, let alone payments with unpredictable timing or in highly variable amounts.

APR WIN recently was replaced by a new tool called the online Annual Percentage Rate program, available at https://www.ffiec.gov/calculators.htm. While the new tool is more robust than APR WIN, and can handle more complex calculations, it is extraordinarily cumbersome to use for irregular payments and is not commercially viable for the APR calculations required by the Proposed Regulations for more complicated finance products. We are not aware of any other commercially available software that can handle such complexity.

In today's marketplace, there are many commercial financing products with daily, weekly, or uncertain payment frequencies, and with payment amounts that cannot be predicted in advance. For this reason, APR is not viable as an annualized rate disclosure unless Department either creates a new tool providers can use to perform the calculations on all commercial financing products, or allows sufficient simplifying assumptions to allow programs like the online Annual Percentage Rate program to be used.

SBFA recognizes and appreciates that the Department has attempted in the Proposed Regulations to provide simplifying assumptions to allow APR to be calculated for the innovative products described above. However, the Proposed Regulations do not go far enough to address the problem. They do not contemplate the Department creating and making available a calculation tool that can perform the required calculations, and the few simplifying assumptions they do provide (such as those stated in Section 3001(d)) do not go far enough to allow existing tools to be utilized.

Sections 2091, 2092, and 3003 appear intended to allow APR for sales-based financing products to be calculated using the assumption that the merchant will remit receivables or make payments in amounts derived from the provider's projections of the recipient's monthly sales. However, the proposed language is ambiguous and not readily understandable by directly affected providers of commercial financing. For example, Section 3003 refers to "reasonably anticipated true-ups," "changes to the split rate over time," and "any other finance charges that may be reasonably anticipated based upon" various factors. These terms are neither generally used in the industry nor defined by the Proposed Regulations.

For certain MCAs, a "true-up" is an adjustment to a remittance schedule based on differences between projected and actual business revenue. For example, if a restaurant that took MCA financing was closed due to COVID-19, its daily remittances could be adjusted downward, or the restaurant could receive a refund, to reflect the fact that delivery-only revenue was less than the MCA provider anticipated when it underwrote the restaurant based on pre-COVID-19 revenue from both in-restaurant dining and deliveries. True-ups by definition are unanticipated, so there are no "reasonably anticipated true-ups." Rather, any attempt to project true-ups is inherently speculative.

Similarly, a "split rate" is an MCA term referring to the percentage of a business's revenue that a credit card processor will pay to the finance company pursuant to an MCA in which a credit card processor "splits" revenue between the merchant and the finance company. Split rates are not ordinarily changed over time except in unusual circumstances not reasonably subject to prediction in advance.

Because the Proposed Regulations use unclear terminology in defining how APRs are to be calculated for products such as MCAs, as well as other forms of financing with variable payment obligations, they should not be adopted as written.

In its September 9, 2019 comment letter, SBFA proposed alternative simplifying assumptions that could be used to address these issues, together with proposed disclosures to ensure that recipients of commercial financing understand their use, but they were not included in the Proposed Regulations. The Initial Statement of Reasons does not describe these alternatives or address why they were rejected by the Department.

B. The ACC Metric Should Be Used Instead of APR Because It Is Easy To Calculate Without The Need For Complicated Assumptions And Software.

Although the Department can make APR disclosures viable by creating and making available new software and/or by permitting the use of more extensive and clear assumptions, SBFA respectfully submits that it would be better to adopt ACC as the annualized rate metric for SB 1235. ACC is simple to calculate by hand or using a commonly available spreadsheet program, and it does not require complex assumptions to be made. The formula is simply: (Total Dollar Cost of Financing/Total Amount of Funds Provided) x (365/Term or Estimated Term) x 100.

In addition to being easy for providers to calculate, ACC also is easy for recipients and examiners to double-check. It avoids the need for complicated assumptions, together with the additional burden examiners would have in confirming that assumptions were made and used correctly. Moreover, it would dramatically simplify Department's task in formulating SB 1235 regulations, which is daunting given the number of commercial financing products requiring viable disclosures and the potentially serious consequences that would result from final regulations that do not adequately address the difficulties of making APR disclosures on products APR was not designed for. In addition to potentially making some forms of commercial financing unavailable in California, unclear or inadequate regulations could require Department to expend significant examination and enforcement resources addressing APR disclosure problems. Given these substantial risks, ACC is a much better option.

C. The ACC Metric Would Cause Less Confusion For Small Businesses.

The issue of recipient confusion is addressed comprehensively by Rapid Advance's comment letter from the first round, and we endorse the views expressed in that letter. In particular, the letter explains in detail how APR was not designed for commercial financing, how regulators such as the Consumer Financial Protection Bureau have found it to be confusing for consumers, and how ACC is a less confusing metric.

SBFA retained Kingsley-Kleimann Group ("KKG") to test various disclosures in commercial financing, including disclosures of APR. KKG is a well-known expert in lending disclosures, as reflected by the CFPB's retention of KKG to help devise its new Loan Estimate and Closing Disclosure. As reflected in the attached report, also available at http://sbfassociation.org/disclosure-study/, KKG found through its research that commercial borrowers have difficulty understanding APR and question its utility.

SBFA wishes to emphasize two important points regarding recipient confusion. First, many commercial financing products do not have an interest rate, and instead charge a fee, precomputed interest, or a purchase price discount. The use of an APR disclosure can only cause confusion regarding these products because the use of the term "APR" suggests that there is an interest rate when there is not (KKG's research confirms this point). This is particularly important because financing products with interest rates become more expensive over time, while many products without interest rates become less expensive over time. Recipients who mistakenly believe their product has an interest rate therefore could seek to pay off their loan or repurchase receivables they sold early, when this typically is not in their financial interest.

<u>Second</u>, the assumptions required for APR calculations on certain products create the potential for additional recipient confusion and harm to providers. For example, one of the principal benefits of sales-based financing is that it ordinarily does not have minimum payment amounts or payment due dates. Small businesses often prefer these products because their revenue fluctuates materially and they prefer to align their financing obligations with their revenue to avoid the risk of default and related stress on their owners. By requiring assumptions such as the recipient making uniform daily payments or remittances so an APR can be calculated, the use of the APR metric inherently risks substantial recipient confusion about the nature of the financing. Recipients who are considering an MCA because they do <u>not</u> want to have to make payments on a regular basis will receive disclosures indicating that there <u>are</u> regular payments, when in fact there are none. This would be bad for small businesses and bad for the providers of these products.

ACC does not present these concerns, so it should be adopted as the annualized cost metric in lieu of APR. If APR is used, SBFA urges the Department to include additional disclosures to make clear that assumptions made for APR calculation purposes are only that – assumptions.

SBFA was pleased to see improvement over prior drafts in this regard, such as in Section 2065, but additional changes should be made to reduce recipient confusion if APR is used. For example, the language in Section 2065(a)(3)(C) helpfully discloses that APR was calculated based on an assumption of monthly income, but it does not disclose the additional (unrealistic) assumption that daily remittances will be in equal amounts. In order to avoid confusion, the recipient also should be told that revenue is likely to fluctuate in practice, and that the actual APR may vary substantially. The language in Section 2065(a)(3)(D) helpfully discloses that APR is not an interest rate and that the finance charges are not based upon an interest rate, but it should seek to avoid confusion by also stating (if applicable) that there is no interest rate, payment schedule, or minimum payments, and (if applicable) that the transaction is not a loan. Section 2065(a)(4)(C) permits disclosure that the "finance charge will not increase if you take longer to pay off what you owe," but it is misleading for products such as MCAs in suggesting that there is a payment obligation and by not stating that the finance charge will decrease if remittances take longer than projected by the provider.

SBFA suggested comprehensive disclosure language that would address these issues for MCAs in its September 9, 2019 comment letter, but the Initial Statement of Reasons did not describe that alternative or explain why it was rejected. On balance, these issues are better addressed by using ACC instead of APR.

The Calculations Underlying the Disclosures for Open-End Products Will Confuse Small Businesses

With respect to open-end credit, instead of following the open-end provisions of the Truth-in-Lending Act and Regulation Z, the Proposed Regulations attempt to convert open-end products into closed-end products by requiring providers to make inaccurate assumptions about how the product will be used. The APR calculations assume an initial draw of the full approved credit limit (a rare occurrence) and regular monthly payments of the minimum amount.[1]

As one example of the problems created by trying to apply closed-end-type disclosures to open-end credit, some financing companies charge a fee whenever there is a draw on the credit line. Because the Proposed Regulations assume a single draw, the provider will disclose a single draw fee rather than the multiple draw fees likely to be charged in practice. When a small business owner inevitably uses multiple draws, that business will be charged fees that were not disclosed because of the inaccurate assumptions required by the Proposed Regulations. At the same time, because the draw fees are not disclosed, some small business owners may select this financing thinking it is less expensive than it really is.

Open-end credit should be disclosed consistent with Regulation Z's open-end disclosures, not in the artificial and inaccurate manner called for under the Proposed Regulations.

Sales-Based Financing

A. Different Disclosures Should Be Required for MCAs

The Proposed Regulations provide a single set of disclosures for all sales-based financing products, despite the fact that some of these are loans and some (MCAs in particular) are not. SBFA believes that disclosures for MCAs should be different because the proposed disclosures are inaccurate for MCAs and would create confusion among recipients.

In litigation seeking to recharacterize MCAs as loans, plaintiffs often point to the use of loan-like language by MCA providers as evidence that the transaction is a loan rather than a true sale of receivables. For this reason, MCA providers should not be required to use the same disclosures as providers of other sales-based financing. Instead, the disclosures should use language

[1] The Proposed Regulations themselves recognize the problem with this type of disclosure when they require the additional disclosure: "Actual costs may differ substantially." Proposed Regulations, § 2062(a)(2).

consistent with the nature of the product. For example, MCA disclosures should not reference "interest."

B. Alternative Estimates/Audits

SBFA supports the Department's proposal to allow certain disclosures regarding sales-based financing to be determined using underwriting data, provided that recipients are clearly advised that the disclosures are only estimates which are likely to vary in practice. However, the proposed language governing these disclosures reflects a misunderstanding of industry practice. In order to avoid unintended consequences, this language should be substantially revised.

Sections 2091 and 2092 provide that certain sales-based financing disclosures may be made using one of two different methods of estimation: the "historical method," which is based solely on the recipient's historical sales, or the "underwriting method," which is based on other, unspecified information. The "historical method" requires the use of historical sales data only, and creates requirements for what data may be used. The "underwriting method" effectively prohibits the use of any other information by imposing an audit requirement that no provider is likely to be able to satisfy given the inherently uncertain nature of these transactions. SBFA respectfully submits that Sections 2091 and 2092 create a false dichotomy between historical revenue information and other underwriting considerations, effectively second-guessing predictions made by providers who have every incentive to make these predictions accurately.

SBFA is unaware of any sales-based financing providers who underwrite MCAs or other sales-based financing transactions without historical revenue information. However, historical revenue information is not the only data considered by providers in underwriting. For example, many providers consider the type of business, industry and economic trends, seasonality, and other predictive factors in order to predict more accurately how long it will take for small businesses to make all payments or remit all receivables in a proposed transaction.

As currently drafted, Section 2091 allows disclosure information to be calculated using historical revenue data only. It restricts the provider's discretion regarding how many months of sales or other revenue data to use, for example prohibiting the use of more than 12 months of data and requiring the same number of months to be used for all proposed recipients. Thus, providers who have found that four months of data is sufficient for dry cleaning businesses, but six are necessary for restaurants, must use the same number of months for all types of businesses. Section 2091 does not allow providers to disclose their predictions of term and other matters if those predictions were based on historical revenue data together with other factors such as economic conditions, even if predictions using additional information are more accurate than historical revenue data alone. Given that providers are fully incentivized to underwrite as accurately as they can, these restrictions will lessen the accuracy of the disclosures. In addition, it would impose unwarranted costs on providers by forcing them to build new systems for generating disclosures from historical data only, rather than using the predictions already generated through their existing underwriting procedures.

Section 2092 does allow the use of other data, but only subject to an audit requirement that no provider can satisfy. The audit requires the provider to review all commercial financings "paid off" during the past four months to calculate the "retrospective annualized rate" for each financing. If the difference in the weighted average of these 20-20 hindsight calculations and the estimated rates disclosed to recipients is too large (greater than 10% difference in the last three audits, or greater than 5% difference in the last five audits), the provider is prohibited from using this method of estimation for two years. However, as many commenters noted in the first round of comments, APRs on sales-based financing (and MCAs in particular) cannot be accurately calculated in advance. MCAs, for example, have no interest rate, no term, and no minimum payments. Given the nature of the MCA product, the estimated APR spread will vary greatly from provider estimates because the cost of an MCA is fixed but the term is variable. MCA providers have no control over how fast or slow a merchant's receivables are generated. Expecting MCA providers to provide APR estimates accurate to within 5 or 10% is simply not realistic.

In order to avoid the cost and burden of audits, as well as the risk of losing the ability to make disclosures using factors other than average historical revenue, SBFA believes that the current draft of these sections would incentivize virtually all providers of sales-based financing to use only the "historical method," despite the fact that it results in less accurate disclosures for small businesses. SBFA therefore suggests that Section 2092 be deleted, and that Section 2091 be modified to require disclosures to be based on the provider's actual predictions from underwriting.

Compliance Safe Harbor

The Proposed Regulations impose obligations on providers that may make it more likely that providers will face legal claims from recipients or third parties in the future. For example, recipients may claim that a provider's disclosure of interest rate, term, or monthly payments was incorrect or misleading when made using estimates. Or, use of certain terms or phrases required by the Proposed Regulations, such as "interest," "prepayment," and "pay off," in the context of non-loan products may increase the risk that a recipient seeks to recharacterize a non-loan product as a disguised loan.

SBFA requests that the regulations specify that the fact that an MCA company has made the disclosures required by the regulations shall not constitute evidence that the MCA is a disguised loan, rather than a true sale of future receivables. Furthermore, the regulations should specify that the fact that a company has made the disclosures required by the regulations, including providing calculations based on specified assumptions, may not be used as the basis for any civil claim against the financing company based on the claim that the assumptions were known to be unrealistic or simplified when made, provided that the assumptions were disclosed in the manner required by the regulations.

* * *

SBFA looks forward to continuing to work with the Department to implement SB 1235 and help serve California's small business community.

Respectfully submitted,

MANATT, PHELPS & PHILLIPS, LLP

By: [redacted]
Scott M. Pearson

Attorneys for Commenter
SMALL BUSINESS FINANCE ASSOCIATION

Attachment

Summary of Short-Term Finance Disclosure Testing for SBFA

Kingsley-Kleimann Group
October 6, 2020

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Executive Summary

An effective commercial loan disclosure must not only present loan terms but must do so in a way that is understandable to target consumers. The language, presentation, design, and metrics must work together to facilitate decision making and to allow individuals to (1) understand loan terms; (2) compare different loan offers; and (3) choose the best loan *for their personal situation*. This qualitative testing project focused on commercial loan disclosures – examining a range of research questions about how well individuals find information, understand the information they find, and use that information to make effective short-term financing decisions.

We tested 24 participants across two rounds of testing: one in Calabasas, CA and one in New York City, NY. Our participants were representative users of commercial loan disclosures – small business owners or executives with experience handling and taking out such loans. The testing explored five research questions and used a one-on-one, think-aloud protocol with follow up cognitive questions. In Round 1, we tested the Capital Comparison Chart Disclosure and three SBFA-developed Disclosures. In Round 2, we again tested the Capital Comparison Chart Disclosure and two SBFA-developed Disclosures.

We analyzed the data using open and axial coding and uncovered the following findings described more fully in the body of the report.

- Finding 1. Participants consider several factors when choosing financing.
- Finding 2. Participants gave rational explanations of why they would choose a short-term financing loan.
- Finding 3. Participants believe the APR is the same as an interest rate.
- Finding 4. Participants could not understand the relationship of the APR to their cost of financing.
- Finding 5. Participants failed to understand that APR is an annual measure being applied – in this case – to a loan with less than an annual term.
- Finding 6. Many participants articulated that the cost of financing is more helpful than the APR.
- Finding 7. Participants need a clear statement of the role of APR to be able to put it into the context of their decision.
- Finding 8. Participants are swayed by APR, but when they examine the relationship of the actual financing to the percentage, they question the APR's use and its utility.
- Finding 9. Though many participants implied or stated that "more information is better" in a disclosure, they could not use the disclosure with the most information effectively.
- Finding 10. Participants found other design options easier to understand than the Capital Cost Comparison.
- Finding 11. Participants rated other measures as more important than APR when asked to rank them.

Overall, we found that participants show sophistication in considering loan terms and considering what those might mean in their situation. They are sensitive to the nuances. At the same time, sophistication does not equal full financial knowledge. Individuals rely on the disclosures to inform them of the "deal" they are entering into. In this context, two key issues emerged from the testing:

Issue 1. More information is not – necessarily – better for individuals. Additional information often gives individuals a sense of security. Armed with more details comes a sense that they have "all they need" to make a decision. However, in this case, more information in the form of the detail-heavy Capital Comparison Chart Disclosure did not aid individuals. In fact, they performed more poorly using this disclosure in cognitive questioning. They were *less* able to identify the payment frequency, the payment amount, or how APR is used.

Issue 2. APR is a complicated measure that does not always aid individuals as intended. The impetus in using APR is to provide a cross-product measure. It is designed to represent to individuals the actual yearly cost of funds over the term of a loan. However, APR – in this context of short-term loan disclosures – has several issues:

- **Individuals conflated APR with interest rate.** They mistakenly believed that the rate they saw on the disclosure was the interest rate. In fact, this is a strong cognitive map for most individuals. They fundamentally believe APR and interest rate are the same thing. They don't understand the differences or what accounts for those differences.

- **Individuals became confused when trying to interpret APR as their interest rate.** In short, individuals tried to "do the math" by assessing the cost of the financing in relation to the overall amount of the loan. The math, of course, didn't add up to the APR. This created confusion. The individuals no longer understood what the APR is or how it related to their loan offer.

- **Because individuals didn't understand APR, they questioned it.** When individuals hit something they fundamentally don't understand, it stops their cognitive process. Individuals were not fully able to use the disclosure because key metrics did not match their long-held cognitive maps.

One serious issue with APR in this context is that the loans are not necessarily annual in nature and are repaid on a daily basis. These factors change the metric, causing a much higher APR than on other loans. APR is often touted as being an "apples to apples" comparison, but in this case, comparing a short-term finance loan to an annual loan is like "apples to avocados." They are very different fruits – though both are sometimes green. Consumers, however, **believe** they are comparing an apple to an apple, and this is a concern. Comprehension is undercut when consumers don't have the cognitive framework to understand a complex construct. It is undercut further when they are asked to use a flawed understanding to make comparisons.

Disclosure design must conform to an underlying philosophy of *understanding.* If consumers do not understand the measures being presented, then the disclosure is not effective. Effective disclosure requires that consumers understand the terms being presented – as fully as possible. In this case, APR is not understood; it introduces questions that consumers cannot easily answer. As one participant, when asked to define APR, answered,: “I feel like you are asking a kid, why is the sky blue?” (Participant 3, NY). In other words, it is ever present yet also inscrutable.

Project Goals

For this project, the Small Business Finance Association contracted with Kingsley- Kleimann Group to better understand how small business owners use disclosures to learn about short-term financing options. A foundational assumption is that consumer disclosures must be understandable to target users and help them make informed decisions. The language, presentation, design, and metrics must work together to facilitate consumer decision making and to allow consumers to (1) understand loan terms; (2) compare different loan offers; and (3) choose the best loan *for their personal situation*.

To assess how well consumers used and understood different short-term finance disclosure designs, we conducted qualitative testing in two sites (Round 1: Calabasas, California and Round 2: New York City, NY). In this testing, we observed consumers as they used various disclosures and then asked follow-up questions to explore the following issues:

1. Do consumers understand the risk of short-term loan options, compared to other products?
2. How well do consumers understand the basic terms of a loan and its costs?
3. Which disclosure design facilitates better understanding of loan terms and costs?
4. How well do consumers understand the concept of APR in relation to a short term (<1 year loan)?
5. What do consumers prefer to see in a disclosure and why?

Our Testing

Who We Tested

We tested 24 participants total with 12 participants in Calabasas, CA and 12 participants in New York City, NY. These participants – each a small business owner or executive in a small business – were a mix of gender, age, race, and ethnicity. They came from a mix of "Main Street" small businesses that included restaurants and bars, clothing boutiques, salons, casting and fine arts companies, consulting firms, and antique shops. No participants were connected to a franchise or chain.

We recruited participants whose small businesses had annual revenues of:

- $200K-$500K (11 participants)
- $500K - $1M (11 participants)
- $1M - $2M (2 participants)

To ensure that our participants had experience with small business financing, we recruited to meet the following requirements:

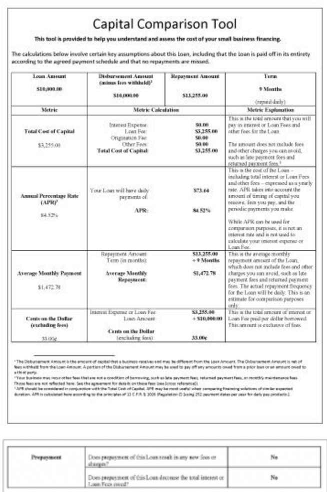
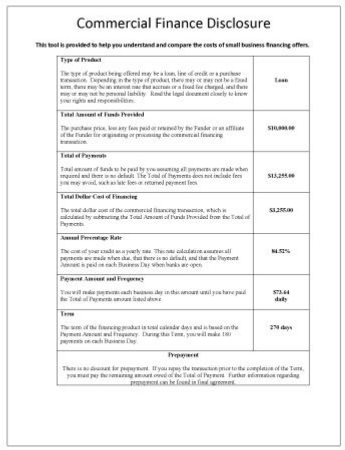
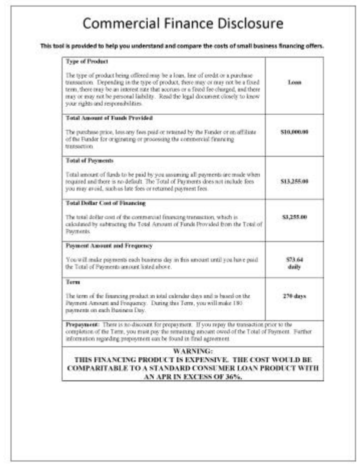
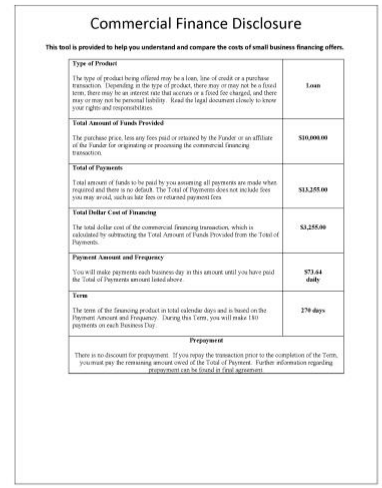
- 8 participants had experience with a Future Receivables Sale Agreement;
- 8 participants had experience with a product that requires daily or weekly payments;
- 8 participants had experience with a Business Loan or Security Agreement; and
- All participants had previously used one of the above products from a vendor.

Test Structure

For each test, we used a one-on-one, think-aloud protocol with follow up cognitive questions. The testing used the following structure.

1. **Context Questions.** Before viewing the disclosures, we asked participants two questions about the important considerations in choosing short-term financing and what would make an individual choose one option over another.
2. **Unstructured Think Aloud.** In each round of testing, we asked participants to read short-term finance disclosures and tell us – out loud – what they were thinking as they reviewed each. (See *Test Disclosure Designs Round 1* and *Test Disclosure Designs Round 2*). This portion of testing was undirected, allowing us to observe what participants thought about the disclosures before we began structured questions. We rotated disclosures so that all participants did not see them in the same order.
3. **Structured Cognitive Questions.** In each round of testing, we followed up the think aloud with a series of structured questions about each disclosure and the offers. We asked questions about elements on the disclosure to assess how well they could use the disclosure to understand basic loan terms and payment terms (such as, *How much will you have to pay in total for this loan?* And, *What is the APR on this loan?*) We also asked about their understanding of key concepts, such as *What does the term [disbursement, metric, capital, cents on the dollar] mean?* and *How would you describe APR in your own words?*
4. **Comparative and Preference Questions.** Finally, we asked what participants found most/least important on the disclosures as well as which disclosures they preferred and why.

Test Disclosure Designs – Round 1

Design 1. Capital Cost Comparison	Design 2. SBFA APR	Design 3. SBFA APR Warning	Design 4. SBFA No APR
 Capital Comparison Tool This tool is provided to help you understand and assess the cost of your small business financing.	 Commercial Finance Disclosure This tool is provided to help you understand and compare the costs of small business financing offers.	 Commercial Finance Disclosure This tool is provided to help you understand and compare the costs of small business financing offers.	 Commercial Finance Disclosure This tool is provided to help you understand and compare the costs of small business financing offers.
Includes (1) Loan amount, disbursement amount, repayment amount; (2) the following metrics with calculations and explanations: Total Cost of Capital, Annual Percentage Rate, Average Monthly Payment, and Cents on the Dollar; (3) Prepayment Penalties, if any.	Includes the Type of Product, Total Amount of Funds Provided, Total of Payments, Total Dollar Cost of Financing, Annual Percentage Rate, Payment Amount and Frequency, Term, and Prepayment Penalties, if any.	Includes the same elements as Design 2 with a Warning at the bottom: "WARNING: THIS FINANCING PRODUCT IS EXPENSIVE. THE COST WOULD BE COMPARITABLE TO A STANDARD CONSUMER LOAN PRODUCT WITH AN APR IN EXCESS OF 36%."	Includes the same elements as Design 2 except for APR.

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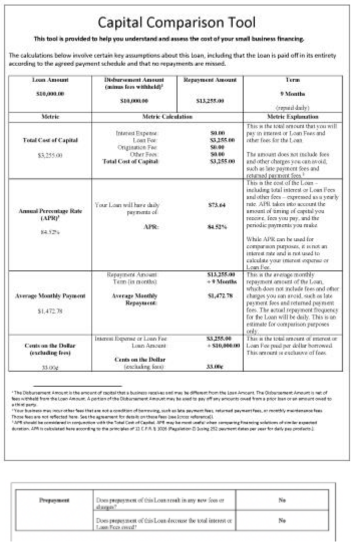
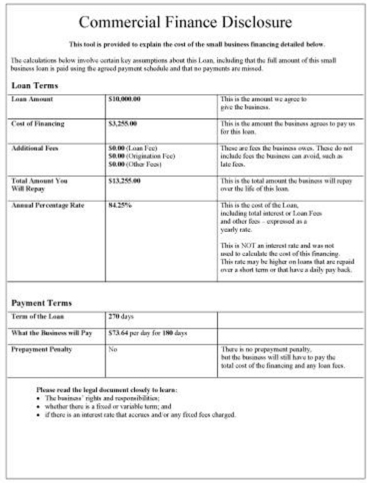
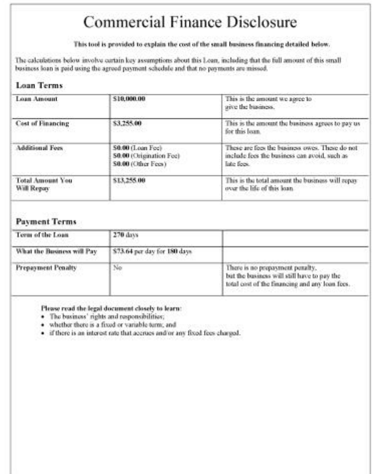
GROUP

Test Disclosure Designs – Round 2

Design 1. Capital Cost Comparison	Design 5. SBFA APR R2	Design 6. SBFA NO APR R2
		
Includes (1) Loan amount, disbursement amount, repayment amount; (2) the following metrics with calculations and explanations: Total Cost of Capital, Annual Percentage Rate, Average Monthly Payment, and Cents on the Dollar; (3) Prepayment Penalties, if any.	Includes (1) Loan Terms, including Loan Amount, Cost of Financing, Additional Fees, Total Amount You Will Repay, Annual Percentage Rate; and (2) Payment Terms, including Term of the Loan, What the Business will Pay, and Prepayment Penalties, if any.	Includes the same elements as Design 6 except for APR.

Design 1 (image 1):

Capital Comparison Tool

This tool is provided to help you understand and assess the cost of your small business financing.

The calculations below involve certain key assumptions about this Loan, including that the Loan is paid off in its entirety according to the agreed payment schedule and that no repayments are missed.

Loan Amount	Disbursement Amount (minus fees withheld)[1]	Repayment Amount	Term
$10,000.00	$10,000.00	$13,255.00	9 Months (repaid daily)

Metric	Metric Calculation		Metric Explanation
Total Cost of Capital $3,255.00	Interest Expense: Loan Fee: Origination Fee: Other Fees: **Total Cost of Capital:**	$0.00 $3,255.00 $0.00 $0.00 $3,255.00	This is the total amount that you will pay in interest or Loan Fees and other fees for the Loan. The amount does not include fees and other charges you can avoid, such as late payment fees and returned payment fees.[2]
Annual Percentage Rate (APR)[3] 84.52%	Your Loan will have daily payments of: **APR:**	$73.64 84.52%	This is the cost of the Loan – including total interest or Loan Fees and other fees – expressed as a yearly rate. APR takes into account the amount of timing of capital you receive, fees you pay, and the periodic payments you make. While APR can be used for comparison purposes, it is not an interest rate and is not used to calculate your interest expense or Loan Fee.
Average Monthly Payment $1,472.78	Repayment Amount: Term (in months): **Average Monthly Repayment:**	$13,255.00 ÷ 9 Months $1,472.78	This is the average monthly repayment amount of the Loan, which does not include fees and other charges you can avoid, such as late payment fees and returned payment fees. The actual repayment frequency for the Loan will be daily. This is an estimate for comparison purposes only.
Cents on the Dollar (excluding fees) 33.00¢	Interest Expense or Loan Fee: Loan Amount: **Cents on the Dollar** (excluding fees):	$3,255.00 ÷ $10,000.00 33.00¢	This is the total amount of interest or Loan Fee paid per dollar borrowed. This amount is exclusive of fees.

[1] The Disbursement Amount is the amount of capital that a business receives and may be different from the Loan Amount. The Disbursement Amount is net of fees withheld from the Loan Amount. A portion of the Disbursement Amount may be used to pay off any amounts owed from a prior loan or an amount owed to a third party.

[2] Your business may incur other fees that are not a condition of borrowing, such as late payment fees, returned payment fees, or monthly maintenance fees. Those fees are not reflected here. See the agreement for details on these fees (see [cross reference]).

[3] APR should be considered in conjunction with the Total Cost of Capital. APR may be most useful when comparing financing solutions of similar expected duration. APR is calculated here according to the principles of 12 C.F.R. § 1026 (Regulation Z) (using 252 payment dates per year for daily pay products).

Prepayment	Does prepayment of this Loan result in any new fees or charges?	**No**
	Does prepayment of this Loan decrease the total interest or Loan Fees owed?	**No**

Design 5 (image 2):

Commercial Finance Disclosure

This tool is provided to explain the cost of the small business financing detailed below.

The calculations below involve certain key assumptions about this Loan, including that the full amount of this small business loan is paid using the agreed payment schedule and that no payments are missed.

Loan Terms

Loan Amount	**$10,000.00**	This is the amount we agree to give the business.
Cost of Financing	**$3,255.00**	This is the amount the business agrees to pay us for this loan.
Additional Fees	**$0.00** (Loan Fee) **$0.00** (Origination Fee) **$0.00** (Other Fees)	These are fees the business owes. These do not include fees the business can avoid, such as late fees.
Total Amount You Will Repay	**$13,255.00**	This is the total amount the business will repay over the life of this loan.
Annual Percentage Rate	**84.25%**	This is the cost of the Loan, including total interest or Loan Fees and other fees – expressed as a yearly rate. This is NOT an interest rate and was not used to calculate the cost of this financing. This rate may be higher on loans that are repaid over a short term or that have a daily pay back.

Payment Terms

Term of the Loan	**270** days	
What the Business will Pay	**$73.64** per day for **180** days	
Prepayment Penalty	No	There is no prepayment penalty, but the business will still have to pay the total cost of the financing and any loan fees.

Please read the legal document closely to learn:
- The business' rights and responsibilities;
- whether there is a fixed or variable term; and
- if there is an interest rate that accrues and/or any fixed fees charged.

Design 6 (image 3):

Commercial Finance Disclosure

This tool is provided to explain the cost of the small business financing detailed below.

The calculations below involve certain key assumptions about this Loan, including that the full amount of this small business loan is paid using the agreed payment schedule and that no payments are missed.

Loan Terms

Loan Amount	**$10,000.00**	This is the amount we agree to give the business.
Cost of Financing	**$3,255.00**	This is the amount the business agrees to pay us for this loan.
Additional Fees	**$0.00** (Loan Fee) **$0.00** (Origination Fee) **$0.00** (Other Fees)	These are fees the business owes. These do not include fees the business can avoid, such as late fees.
Total Amount You Will Repay	**$13,255.00**	This is the total amount the business will repay over the life of this loan.

Payment Terms

Term of the Loan	**270** days	
What the Business will Pay	**$73.64** per day for **180** days	
Prepayment Penalty	No	There is no prepayment penalty, but the business will still have to pay the total cost of the financing and any loan fees.

Please read the legal document closely to learn:
- The business' rights and responsibilities;
- whether there is a fixed or variable term; and
- if there is an interest rate that accrues and/or any fixed fees charged.

Findings

Finding 1. Participants consider several factors when choosing financing. Participants mentioned a range of factors when comparing and selecting short-term financing options. These are the factors mentioned (in order of most-often mentioned):

- Payback terms (including payment frequency and term of loan)
- Interest rate
- Legitimacy of lender
- Cost of the money borrowed
- Grace period for repayment
- Penalties applied

These considerations tended to frame or contextualize the participants' experience with the loan disclosures. For example, participants who mentioned payback terms tended to be interested in learning about those elements; participants who were interested in cost of money tended to be interested in learning about that element.

Finding 2. Participants gave rational explanations of why they would choose a short-term financing loan. Participants understood the purpose of short-term financing options and could articulate why they might take such a loan. In general, they had rational explanations including

- A desire for easy, fast financing;
- A need for only a "short-term" cash infusion to cover a temporary period; or
- A desire for a loan that they could pay back quickly.

Participants also understood that there were a range of financing options and that some may be better or worse for a company *depending on the situation*. They appeared to understand the concept of "risk" in short-term financing. Many had also, in fact, taken different types of short-term financing.

- *Was I surprised by the actual [APR] number? Yes. Is it something I'm really surprised about? No. So I feel like it is something that we kind of have to live with given the fact that the terms are very short and it is only for 180 days. But of course, like I said, I would see what other lenders are offering. (Participant 4, NY)*

- *I mean, it's hard to explain when you're really desperate for money and you - it's almost like - it's not that you don't care, you do care and you know you're paying a high amount. (Participant 8, NY)*

Finding 3. Participants believe the APR is the same as an interest rate. When asked to tell us in their own words what an APR is, most participants appeared to conflate it with an interest rate. Most participants believe it is assigned by the lender to the loan – e.g., "we are giving you a loan at 85% interest rate"; a few believe it is related to government-set rates, such as the FDIC. Only one participant – even among many who appeared otherwise financially literate – could accurately describe APR.

- *APR is the percentage that you basically pay the institution for them to let you use their money and they decide what percentage they're going to charge you in addition to the funds that your borrowing from them. (Participant 12, NY)*
- *If you have a $1000 credit card bill and you don't pay it and the APR is 84%, then you're going to tack 84% interest on that $1000 (Participant 1, NY)*
- *APR is something that's regulated by, I want to say, the government or banks that's attached to these loans to figure out their interest rate back to them. (Participant 7, CA)*
- *It's the percentage they are taking off of your principal to make that loan. That's their interest rate. (Participant 8, CA)*

Finding 4. Participants could not understand the relationship of the APR to their cost of financing. Many participants tried – and failed – to make the "math" work on the APR in relation to the actual cost of financing. Therefore, they struggled to understand how the APR was calculated and how it related to the money they were borrowing.

- *How do you get the 84.25% amount? There's something I'm not understanding about this…if I understand it correctly, which maybe I don't, but it seems like you're owing close to 30%? (Participant 6, CA)*
- *Why is it 84.52%?...when I look at the interest and calculate it at $6500 back, just trying to think of the numbers, something is just not making sense to me. (Participant 7, CA)*
- *I don't understand how the APR is 84%. A ten thousand loan, I'm repaying you $3,250….It's confusing because just in simple math terms, it's not adding up. (Participant 5, NY)*

In many ways, the underlying misunderstanding of APR was the key. Because participants implicitly believe this is their interest rate, they could not reason their way through how the percentage factored into the big picture. Additionally, only one participant fully understood that APR compounded daily and that it would be affected by the daily payment schedule.

Finding 5. Participants failed to understand that APR is an annual measure being applied to a loan with less than an annual term. APR had an additional, and important, downside. Because it is an annual rate, it appeared to confuse people because these short-term loans are less than an annual term.

- *I was just assuming it [the loan] was an annual thing as opposed to six months or nine months or what have you…I'm still not clear the APR's importance in determining the cost of the loan. Is it involved or is it not? (Participant 1, NY)*
- *If it is a nine-month loan, I guess you would have to give a theoretical case. So, if this loan were paid over this period of time – a year – because APR is based on a year. You have to transpose it for a year. (Participant 3, NY)*
- *It [the APR] reads really high. And I probably wouldn't figure out that it's because it's only nine months, and it's payment every day. (Participant 7, NY)*

Finding 6. Many participants articulated that the cost of financing is more helpful than the APR. Many participants stated – at the outset of testing – that the most important part of the financing was the cost and the payments. Even those participants who liked the concept of APR expressed concerns that the percentage given didn't match their understanding of the interest rate and then focused more on the actual cost of financing.

- *To me, personally, like I have done one of these things before, the APR doesn't really factor into the decision. If I know exactly what I'm paying back and what I'm getting over that timeframe, I have the comparison there. (Participant 5, CA)*
- *I don't know if that [APR] is relevant or not relevant… you know what the total amount is, so the amount of interest is probably less significant. (Participant 10, CA)*
- *The APR may be a legal thing you have to disclose, but…I feel much more comfortable with the average monthly payment, which is saying the same thing I suppose. $13,255 over nine months. That's very clear how much I will pay. (Participant 3, NY)*
- *My very first impression was like "Whew, 84%, that's really high!" Right?…I'd be a little taken by that number, 84.25%. But then when you read it, it's like, okay the cost is $3,200. I like that it has the actual cost of that capital because it's a more understandable number. (Participant 7, NY)*

Finding 7. Participants need a clear statement of the role of APR to be able to put it into the context of their decision. Because the percentages can be very high in short-term financing, participants need a stronger and clearer statement of what APR is in this context to be able to effectively contextualize the information. In New York, participants better understood the explanation of the APR in the SBA APR version, which often made them further question APR and its role.

- *There's a perception on that first one [CCC]: "Wow that seems like a high number. That seems like a high percentage." Then, on the second document [SBFA APR R2] it says its actually not being used…" (Participant 10, NY)*

- *I think that people think of APR as being the interest rate. I think those two things in my head are the same. They're just different words. But it turns out they're not [after reading SBFA APR R2]. But I think that's a misconception that a lot of people have. So, I think that will confuse people. (Participant 2, NY)*

Finding 8. Participants are swayed by APR, but when they examine the relationship of the actual financing to the percentage, they question its use and its utility. As participants used disclosures, it became more apparent to them that the APR doesn't match the interest rate. This disconnect caused them to question the use of APR and how important it should be in their decision making process.

- *I mean if I was from the lender's point of view, you know, putting 84.25% seems like the wrong number. Maybe it is the truth, but it just seems like the wrong number. I think it would be confusing to me why the APR was so high and it would scare me...but then it would also confuse me. (Participant 2, NY)*

- *I think the APR thing, if you can get it where it's less confusing and a little more straightforward. It's fine to put it in, but I was fine not having it in the third one [SBFA NO APR R2] (Participant 1, NY)*

- *It's funny because the APR not being there, it doesn't change the fact of what the numbers are. (Participant 10, NY)*

Finding 9. Though many participants implied or stated that "more information is better" in a disclosure, they could not use the disclosure with the most information effectively. Many participants liked that the CCC offered more information and often, initially, mentioned liking the additional information. However, they performed more poorly with that design on cognitive questions. For example, participants were more likely with the CCC than with SBFA versions to make mistakes including:

- Not being able to answer how often payments are made, since they missed the daily repayment at the top.

- Answering that payments are made monthly, since they misinterpreted "Average Monthly Payment" as "Monthly Payment."

- Not being able to define terms used like disbursement, metric, or cents on the dollar.

A perfect example was Participant 5 in NY who stated clearly that he wanted more information and preferred the CCC for that reason, but in the same statement, demonstrated that the disclosure had not given him the payment amount or schedule. The disclosure gave him plenty of information, but not the information he needed.

- *It [CCC] has more information which is better. Again, I really want to ask questions about payments. Is it weekly? I would need to sit and do the math…how are we going to get to that $13,255. (Participant 5)*

Participant 5 was not the only participant who struggled with a desire for more information and yet had a misunderstanding of the information presented. Some participants recognized and spoke about the confusion of more information and a visual presentation that didn't organize information clearly.

- *The third one [CCC) gave me more information. It also gave me more questions. (Participant 2, NY)*
- *I didn't need the cents on the dollar, like all of that other stuff was peripheral and more like a distraction [in CCC]. This [SBFA APR R2] gets right down to it and answers all my questions and not only that, but visually speaking…this one is very clear. (Participant 3, NY)*
- *I love seeing numbers and I love seeing charts like this but this one [CCC] already looks pretty confusing. (Participant 11, CA)*
- *The other one [CCC] I felt like it was like that ideology of reading the fine print and really understand and this one was just more straightforward and…honest and transparent about what these actual terms are. (Participant 4, NY)*

Finding 10. Participants found other design options easier to understand than the Capital Cost Comparison.

Round 1
We asked participants to rate the perceived difficulty of the disclosure on a scale from 1 to 5 with 1 being the most difficult and 5 being the least difficult. Design 2. SBFA APR scored as least difficult of all, and was considered easier than Design 1. Capital Cost Comparison.

Round 2
In Round 2, using the same scale, both Design 5. SBFA APR R2 and Design 6. SBFA NO APR R2 were considered less difficult than Design 1. Capital Cost Comparison.

Finding 11. Participants rated other measures as more important than APR when asked to rank them.
We asked participants to rank four comparative items in terms of their importance in selecting a loan. Overall, across all 24 participants, the rankings were as follows:

1. Dollar Cost of Financing

2. Payment Amount and Frequency

3. Annual Percentage Rate

4. Total Amount of Payments

Discussion

Testing demonstrated that most small business owners and executives were thoughtful individuals. They were not wildly irrational, and they were savvy at making informed decisions based on their values, beliefs, concerns, and personal situations. As small business owners and executives, they understand – more than most – the concept of personal and financial risk and use that framework to assess short-term financing.

Participants showed sophistication in considering loan terms and considering what those might mean in their situation. They were sensitive to the nuances. At the same time, sophistication does not equal full financial knowledge. Small business owners rely on commercial disclosures to inform them of the "deal" they are entering into. In this context, two key issues emerged from the testing:

Issue 1. More information is not – necessarily – better for individuals. Additional information often gives individuals a sense of security. Armed with more details comes a sense that they have "all they need" to make a decision. However, in this case, more information in the form of the detail-heavy Capital Comparison Chart Disclosure did not aid individuals. In fact, they performed more poorly using this disclosure in cognitive questioning. They were *less* able to identify the payment frequency, the payment amount, or how APR is used.

Issue 2. APR is a complicated measure that does not always aid individuals as intended. The impetus in using APR is to provide a cross-product measure. It is designed to represent to individuals the actual yearly cost of funds over the term of a loan. However, APR – in this context of short-term loan disclosures – has several issues:

- **Individuals conflate APR with interest rate.** They mistakenly believe that the rate they see on the disclosure is the interest rate. In fact, this is a strong cognitive map for most individuals. They fundamentally believe APR and interest rate are the same thing. They don't understand the differences or what accounts for those differences.

- **Individuals become confused when trying to interpret APR as their interest rate.** In short, individuals try to "do the math" by assessing the cost of the financing in relation to the overall amount of the loan. The math, of course, doesn't add up to the APR. This creates confusion. The individuals no longer understand what the APR is or how it relates to their loan offer.

- **Because individuals don't understand APR, they question it.** When individuals hit something they fundamentally don't understand, it stops their cognitive process. They no longer know how to use the disclosure because key metrics don't match their long-held cognitive maps.

One serious issue with APR in this context is that the loans are not *necessarily* annual in nature and are repaid on a daily basis. These factors change the metric, causing a much higher APR than on other loans. APR is often touted as being an "apples to apples" comparison, but in this case, comparing a short-term finance loan to an annual loan is like "apples to avocados." They are very different fruits – though both are sometimes green. Consumers, however, **believe** they are comparing an apple to an apple, and this is a concern. Comprehension is undercut when consumers don't have the cognitive framework to understand a complex construct. It is undercut further when they are asked to use a flawed understanding to make comparisons.

Disclosure design must conform to an underlying philosophy of *understanding.* If consumers do not understand the measures being presented, then the disclosure is not effective. Effective disclosure requires that consumers understand the terms being presented – as fully as possible. In this case, APR is not understood; it introduces questions that consumers cannot easily answer. As one participant, when asked to define APR, answered,: "I feel like you are asking a kid, why is the sky blue?" (Participant 3, NY). In other words, it is ever present yet also inscrutable.