

Date of Hearing: April 18, 2022

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

AB 2314 (Petrie-Norris) – As Amended March 24, 2022

**SUBJECT:** State-guaranteed commercial financial products for small businesses: Small Business Expansion Fund: Capital Access Loan Program

**SUMMARY:** Establishes transparency and eligibility standards for financial institutions that participate in the Small Business Loan Guarantee Program, administered by the California Infrastructure and Economic Development Bank (I-Bank), and the Capital Access Program (CalCAP), administered by the California Pollution Control Financing Authority (CPCFA).

Specifically, **this bill:**

- 1) Requires a loan guarantee funded by the federal State Small Business Credit Initiative Act of 2010, as modified by the American Rescue Plan Act of 2021, to be issued only if:
  - a) The guaranteed loan does not require the borrower to sign a confession of judgment, as defined.
  - b) The guaranteed loan is not refinanced or renewed, and is not used to refinance or renew another loan, if the new loan includes unpaid or unaccrued interest or fees, as defined, to pay off the balance of the previous loan.
  - c) The final payoff amount that is not varied based on the source of funds used to make the final payoff
  - d) The guaranteed loan repayment information must be sent to a commercial credit reporting agency, as defined, and credit data must be consulted when underwriting the guaranteed loan.
  - e) The guaranteed loan's borrower and any guarantors must be informed if the financial institution or corporation intends to report loan repayment performance to a commercial credit reporting agency if a default occurs.
  - f) The guaranteed loan must follow a schedule of conditions concerning hidden payment charges, as specified. For example, the guaranteed loan must disclose financing charges other than interest accrued since the last payment as "prepayment charges" and the guaranteed loan must disclose potential prepayment charges and penalties in any loan offer summary.
  - g) The guaranteed loan must be given to a borrower that can afford the loan or that has a credible path to profitability, meaning that the4 firm has a debt-service coverage ration greater than 1.00.
  - h) The guaranteed loan must be given to a borrower that can afford the loan or that has a credible path to profitability if the financial institution received repayment from the borrower's gross receipts, such as through credit cards, that prevent the borrower from paying for operating expenses first.

- 2) Defines “participating financial institution,” as defined for the purposes of the administration of CalCAP, to include [sic] a participating financial institution that engages in unfair, unethical, or nontransparent practices with small businesses, such those identified in #1 above as well as:
  - a) participating financial institution may not provide information required for prepayment beyond two days from the date upon which the borrower requests to prepay or refinance a loan.

**EXISTING LAW:**

- 1) Establishes the California Small Business Finance Center (SBFC) within the California I-Bank for the purpose of overseeing programs locally delivered through a network of small business financial development corporations (FDCs). (GC § 63088 et. seq.)
  - a) Establishes Small Business Expansion Fund, to provide guarantees to loans offered by financial institutions and financial companies to small business (Gov Code Sec. 63089.70).
  - b) Prohibits a FDC from issuing a guarantee unless it determines the following conditions are satisfied:
    - i) There is a low probability that the loan being guaranteed would be granted by a financial company or financial institution under reasonable terms and conditions and the borrower has demonstrated a reasonable prospect of repayment.
    - ii) The loan proceeds will be used exclusively within California.
    - iii) The loan qualifies as a small business loan or an employment incentive loan.
    - iv) The borrower has a minimum equity interest in the business as determined by the directives and requirements.
    - v) The jobs generated or retained demonstrate reasonable conformance to any directives and requirements specifying employment criteria (Gov. Code Sec. 63089.71).
  - c) Establishes the CPCFA within the Office of the Treasurer to provide low-cost financing to California businesses.
  - d) Creates CalCAP (Gov Code Sec. 63089.70) to encourage banks and other financial institutions in California to make loans to small businesses that have difficulty obtaining financing

**FISCAL EFFECT:** Unknown. This bill is keyed Fiscal by Legislative Counsel.

**COMMENTS:**

- 1) **Purpose.**

According to the author:

This bill requires any commercial financing products that leverage state funding—such as loan guarantee programs—to include several financing rights and protections for borrowers.

Thanks to new and innovative online financial products, many small businesses in California have a new lifeline that provides smaller yet vital cashflow that banks often cannot provide. However, due to a lack of regulation, many bad actors purposely hide critical information that small businesses rely on to raise capital, unexpectedly leaving them mired in debt. Borrowers deserve transparent information to make educated decisions that are important to their cashflow and lifeline.

- 2) **Background.** Generally speaking, small businesses have less access to credit and low-cost loans than larger, more established companies. This is often because of the incentives inherent in lending: larger businesses tend to have longer credit histories and greater cashflows, and a bank or other lender will make the reasonable determination that they are more creditworthy.

However, these inequities are worse for minority-owned and women-owned businesses. Research indicates that these small business owners face many of the challenges all small business owners face, but they must also overcome explicit and implicit bias and the lack of a pre-existing relationship with a business lender. In response, in September 2021 the federal Consumer Financial Protection Bureau (CFPB) announced a proposal to require lenders to collect and report data about credit applications from small businesses, including women-owned and minority-owned businesses, in order to shed light on whether lenders are meeting the needs of small businesses. Specifically, CFPB's proposal would include data on credit applications, including the purpose, type, and amount of credit and the amount approved or originated, as well as demographic information about small business owners. CFPB states this proposed rule would help in "allowing community organizations, researchers, lenders, and others to better support small business and community development needs."<sup>1</sup>

To help address inequities in commercial lending, the federal government has also provided funding to states to support public sector efforts to boost small business lending. The federal Small Business Jobs Act of 2010 created the State Small Business Credit Initiative (SSBCI) and allocated \$168 million to California to strengthen these efforts, and the initial allocation was split equally between I-Bank's Small Business Finance Center (SBFC) and the CPCFA to support the following two programs:

- a) **SBFC's Loan Guarantee Program.** Loan guarantees are the most common type of publically-provided lending assistance. Under a loan guarantee program, a public agency works with participating lenders to guarantee a portion of individual loans, ensuring that the lender is paid the portion of an outstanding balance in case the borrower defaults.

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<sup>1</sup> "CFPB Proposes Rule to Shine New Light on Small Businesses' Access to Credit," Consumer Financial Protection Bureau (September 2021), available at: <https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-shine-new-light-on-small-businesses-access-to-credit/>

Under I-Bank's loan guarantee program, SBFC works with seven FDCs to guarantee up to 80% of qualified loans, up to \$2.5 million. As of March 2022, 121 lenders participate in the program, and in 2019-20 the SBFC guaranteed 470 loans totaling \$24 million.

- b) **CPCFA's CalCAP and Collateral Support Program.** Under a capital access program, a public agency insures loans through a loan loss reserve fund. In many cases, the lender, the borrower, and the public agency will all add funds to the loan loss reserve fund, and the lender can file a claim to the fund for the outstanding balance of a defaulted loan.

CalCAP is a loan portfolio insurance program created in 1994 to encourage lenders to make loans to small businesses. CalCAP provides up to 100% coverage to participating lenders on losses as a result of certain kinds of loan defaults, which in theory makes a lender more comfortable underwriting a small business loan.<sup>2</sup> As of March 2022, 20 lenders participate in CalCAP. In 2020, CalCAP lenders made 5,312 loans totaling \$362 million. CalCAP also administers several narrowly targeted programs, such as for seismic retrofits and electric vehicle charging equipment, that support fewer loans. CalCAP deposited \$36 million into lenders' loan loss reserve accounts in 2020. CPCFA also administers a collateral support program that was created in 2013 and in 2020, the Collateral Support Program contributed \$7 million to support 41 new loans to small businesses.

According to the Legislative Analyst's Office (LAO), between 2010 and 2016 this SSBCI funding supported 10,286 new loans, and about 40% of the dollar amount of these loans was made to businesses in low-and-moderate-income communities. Today, both programs are expected to see significant funding increases: The American Rescue Plan Act of 2021 included an additional \$10 billion to support state programs that facilitate small business financing, and California is expected to receive an estimated \$1.1 billion, with those funds being shared between I-Bank and the CPCFA.

### 3) **The Small Business Borrowers' Bill of Rights.**

AB 2314 incorporates many of the concepts developed by the Responsible Business Lending Coalition's (RBLC's) Small Business Borrowers' Bill of Rights. The RBLC is a network of nonprofit and for-profit lenders, investors, and small business advocates that "share a commitment to innovation in small business lending and serious concerns about the rise of irresponsible small business lending."<sup>3</sup> In 2015, the RBLC created the Small Business Borrowers' Bill of Rights, advertised to be the first cross-sector consensus on the rights that small business owners deserve and what financing providers, brokers and lead generators can do to uphold those rights.

While not all items in the Small Business Borrowers Bill of Rights are included in this bill, a number of the new standards and rules for the SBLGP and CalCAP flow directly from the RBLC document. The following, lifted directly from the RBLC webpage, are concepts found in this bill:

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<sup>2</sup> "State Small Business Credit Initiative," California State Treasurer's Office (accessed April 2022), available at <https://www.treasurer.ca.gov/cpcfa/calcap/sb/ssbci.asp>.

<sup>3</sup> See an overview of RBLC and its Small Business Borrowers' Bill of Rights here: <http://www.borrowersbillofrights.org/rblc.html>

**Alignment of Interests.** Lenders who receive repayment directly from the borrower's gross sales must also verify, through documents, data from third parties, and/or due diligence, that the borrower can repay all debt and remain profitable, or that it has a credible path to profitability. Lenders should not make loans that the borrower cannot truly afford, even if the lender can find a way to be repaid."

**Right-sized financing.** Size loans to meet the borrower's need, rather than to maximize the lender's or broker/lead generator's revenue. Seek to offer the borrower the size of loan that they need, rather than offering the largest amount they could qualify for."

**Responsible credit reporting.** Report loan repayment information to major credit bureaus and consult credit data when underwriting a loan. Such reporting enables other lenders to responsibly underwrite the borrower and helps the borrower build a credit profile that may facilitate access to more affordable loans in the future. Lenders must inform the borrower and any guarantors if they intend to report loan repayment performance to guarantors' credit bureaus only in certain circumstances, such as after a default.

**No Hidden Prepayment Charges.** If, in the event of prepayment, the borrower will be required to pay financing charges other than interest accrued since the last payment, disclose these charges as "prepayment charges." Also disclose any additional charges or fees added in the case of prepayment as "prepayment penalties." Disclose (a) the potential amount of these prepayment charges and penalties in any loan offer summaries, and (b) the actual prepayment charge and penalties at the time of any prepayment. In the case of financing with payments that vary as a percentage of the borrower's sales, a payoff event is considered prepayment if the borrower states the intent to pay off the financing, or in any event of refinancing.

**Fair Prepayment.** If a borrower requests to prepay or refinance a loan, provide any information required for prepayment within two business days of the borrower's request. To enable small businesses to access the most appropriate financing, the final payoff amount should not vary based on the source of funds used for payoff, funds from a third-party should be considered equivalent to funds from the borrower.

#### 4) **Other commercial financing disclosures.**

AB 2314 is not the first attempt to put in place standards around small business lending. SB 1235 (Glazer), Chapter 1011, Statutes of 2019, requires a commercial lender who facilitates commercial financing, such as closed-end loans, open-end lines of credit, merchant cash advances, and accounts receivable financing, to provide certain disclosures related to the cost and terms of the financing. Specifically, SB 1235 tasked the Department of Financial Protection and Innovation (DFPI) to adopt regulations concerning an annualized rate disclosure, total amount of funds, the total dollar cost of the financing, the terms, the method, frequency, and amount of payment, and a description of prepayment policies.

A key obstacle to enacting universal commercial financing standards are the variety of business models and regulatory structures covering those who lend to businesses. SB 1235 attempted to resolve this by putting the bill's provisions outside the most relevant state law (CFL) and applying them to CFL licensees making commercial loans as well as other entities not covered under the CFL, including nondepository entities partnering with banks.

AB 2314 builds off of SB 1235 by proposing *additional* standards around credit reporting, right-size financing, and prepayment charges for those lenders participating in SBFC's loan guarantee program and CPFA's CalCAP.

## 5) **Staff comments and questions**

AB 2314 promotes some of concepts found in the Small Business Bill of Rights by making participation in two state programs conditional on a lender's compliance with specified disclosures and lending standards. However, the bill's current drafting raises a number of policy questions about whether this approach would meaningfully improve standards around these programs and whether they can be enforced. As the bill moves through legislative process, the author may wish to consider additional amendments that help assuage fears that this bill could lead to unintended consequences that undermine these programs' effectiveness. Questions include:

### a) **How is it enforced?**

It is unlikely program staff at I-Bank and the CPCFA can enforce the standards imposed under this bill. For example, the SBFC has just a handful of program staff who work with local FDCs to coordinate loan guarantees. Under the current practice, the FDCs typically vet lenders, but this bill would create an obligation for the SBFC and its small team to take additional compliance steps.

The CPCFA would similarly face challenges. STO staff indicate this bill would require the CPCFA to become an enforcement agency since the CPCFA does not determine the underwriting standards or loan issuance practices of participating financial institutions, which are governed by other laws.

### b) **Would this push out some lenders and cause delays?**

It is unclear if this bill, by removing some flexibility and imposing additional standards on participants, would lead to some lenders exiting the programs altogether. Since these programs exist in large part to encourage lenders to engage in lending activity they may not otherwise engage in, any changes to these programs that impose additional compliance costs onto lenders may make participation unfeasible.

It is important to note that the standards themselves may not be the sole issue here. For instance, many of the lenders participating in the SBFC's loan guarantee program are already likely in compliance with this bill since FDCs typically partner with lenders that are in compliance with the Small Business Lending Bill of Rights.

Instead, this bill could gum up the works and impose additional compliance costs on all parties. By requiring state agencies to take a closer look at the underwriting standards and loan issuance practices of financial lenders and by taking away flexibility for financial institutions, AB 2314 could also lead to excessive delays. Since the SSBCI program requires state agencies to deploy funds quickly in order to receive the next tranche, such delays could have an impact on these programs' impact.<sup>4</sup>

## 6) Proposed amendments.

The committee recommends the below amendments to fix a drafting error as well as remove language unnecessary to the bill's goals that assert that a financial institution is engaging in "unfair, unethical, or nontransparent practices" if it does not comply with the bill's proposed standards. Specifically, the committee recommends the following amendments:

SEC. 3. Section 44559.1 (f) of the Health and Safety Code is amended to read:

"Participating financial institution" means a financial institution that has been approved by the authority to enroll qualified loans in the program ~~and program~~, has agreed to all terms and conditions set forth in this article and as may be required by any applicable federal law providing matching funding. ~~"Participating financial institution" includes, but is not limited to, participating financial institutions that engage in unfair, unethical, or nontransparent practices with small businesses, such as funding, and complies with~~ the following:

- (1) The ~~participating~~ financial institution shall not require the borrower of the qualified loan to sign a confession of judgment, as ~~defined in subdivision (a) of~~ specified in Section 1132 of the Code of Civil Procedure.
- (2) The ~~participating~~ financial institution shall not refinance or renew a qualified loan, nor shall it use a qualified loan to refinance or renew another loan, if the new loan to refinance or renew includes ~~unpaid or unaccrued interest or fees, charges,~~ as defined in Section 22500 of the Financial Code, to pay off the balance of the previous loan.
- (3) The ~~participating~~ financial institution may not provide information required for prepayment beyond two days from the date upon which the borrower requests to prepay or refinance a loan.
- (4) The ~~participating~~ financial institution shall not vary the final payoff amount of the guaranteed loan based upon the source of the funds used to make the final payoff.
- (5) The ~~participating~~ financial institution shall consider repayment funds from a third party as equivalent to funds from the borrower.
- (6) The ~~participating~~ financial institution shall send repayment information to a commercial credit reporting agency, as defined in subdivision (b) of Section 1785.42 of the Civil Code, and credit data shall be consulted when underwriting the guaranteed loan.

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<sup>4</sup> See the US Treasury Department's SSBCI Frequently Asked Questions (Updated March 2, 2022) for more information: <https://home.treasury.gov/system/files/136/SSBCI-FAQs-as-of-3-2-2022.pdf>

(7) The ~~participating~~ financial institution shall inform the borrower and any guarantors ~~shall~~ if it intends to report guaranteed loan repayment performance to a commercial credit reporting agency if default occurs.

(8) The ~~participating~~ financial institution shall ensure that the borrower can afford the loan or that it has a credible path to profitability, meaning that the borrower has a debt service coverage ratio greater than 1.00.

(9) The ~~participating~~ financial institution shall ensure that the borrower can afford the loan or that it has a credible path to profitability if the financial institution receives repayment directly from the qualified loan's borrower's gross receipts, such as through credit card, payments processing, or daily payments, that prevents that qualified loan's borrower from paying for operating expenses first.

(10) The ~~participating~~ financial institution shall follow a schedule of conditions concerning hidden payment charges, as follows:

(A) The qualified loan shall disclose financing charges other than interest accrued since the last payment as ~~"prepayment charges."~~ prepayment charges.

(B) The qualified loan shall disclose any additional charges or fees added in the case of prepayment as ~~"prepayment penalties."~~ prepayment penalties.

(C) The qualified loan shall disclose potential prepayment charges and penalties in any loan offer summary

## **REGISTERED SUPPORT / OPPOSITION:**

### **Support**

CAMEO - California Association for Micro Enterprise Opportunity (Sponsor)  
Pacific Community Ventures  
Small Business Majority

### **Opposition**

None on file.

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