ELECTRONIC TRANSACTIONS ASSOCIATION
Advancing Payments Technology

Beyond APR – Understanding Small Business Lending

Online lending has expanded access to capital for small business borrowers. Online lenders are willing to provide small businesses with small loans (typically less than $250,000) and shorter terms that are often well suited for their day-to-day operating needs or short-term use cases. As the market for these loans grows, ETA supports transparency in small business loan disclosures, including providing borrowers with the best information to compare costs and make informed decisions.

ETA is concerned, however, by a perceived singular focus on annual percentage rate (APR) disclosure for small business loans. While APR is often an effective way to compare the cost of credit on long-term *consumer loans*, such as a mortgage, it does not always provide small businesses with complete information about a financing option. It is critical to note that APR does **not** present the total dollar amount a borrower will pay in interest in a year and the calculation is duration sensitive.

The traditional metric for measuring the dollar cost of commercial loans is the total cost of capital (TCC), which enables a small business to determine easily the "affordability" of a loan in the form of principal plus interest expense and to most effectively match the loan to a particular business need or use-case. Indeed, most small business borrowers turn to TCC because it provides clear information for matching the cost of commercial credit products with the borrowers' expected return on investment. For example, if a small business expects a $10,000 loan to cost $1,000 in interest (or 10 cents for every dollar borrowed), then it is easy to assess if the proceeds will be used to purchase inventory that will drive a 50% profit margin (or 50 cents for every dollar).

What is an Annual Percentage Rate (APR)? What is the Total Cost of Capital (TCC)?

Generally, when consumers take out a loan, they are not making an income-generating investment that would increase the funds available to pay the loan back. Therefore, in most situations, the more "affordable" loan for a consumer is one with a longer term and lower monthly payments, even if it results in paying more over the long term. Consumers, therefore, look at APR, which describes the interest and all fees that are a condition of the loan as an annual rate paid by a borrower each year on the outstanding principal during the loan term. APR takes into account differences in interest rates and fixed finance charges that may otherwise confuse a consumer borrower and is most useful in comparing similarly long-term loans, such as 30-year mortgages or multi-year auto loans. Likewise, APR is useful for comparing revolving lines of consumer credit, like credit cards, where the amount borrowed each month changes. APR allows consumers to compare the rate at which an outstanding balance would increase under different credit cards.

While APR describes the cost of the loan as an annualized percentage, TCC represents the sum of all interest and fees paid to the lender. As the Cleveland Federal Reserve recently noted, TCC enables a small business to determine the "affordability" of a product – a key driver for most small business borrowers. Unlike consumer loans, commercial loans are normally used to generate revenue by helping a business purchase equipment or inventory or hire additional employees. Thus, "affordability" for small business borrowers means assessing the cash flow impact of the loan and comparing the TCC of the loan and the return they expect to earn from investing the loan proceeds. To reduce TCC, many small business borrowers prefer short-term financing they can quickly pay back with the return on their investment (ROI).

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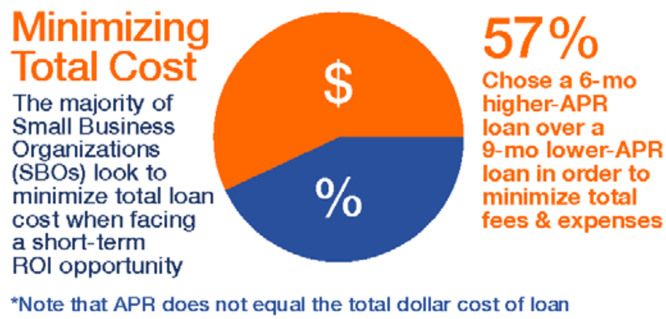
- In a recent ETA survey conducted by Edelman Intelligence of almost 600 small business borrowers, a majority of respondents stated that they would look to minimize TCC, rather than APR, when considering loan options in the face of a short-term ROI opportunity.



How Does an Annual Percentage Rate (APR) Compare to Total Cost of Capital (TCC)?

APR provides a useful comparison for long-term consumer loans and credit cards, but may have less comparative value for small business financing for several reasons:

- APR calculations are highly duration-sensitive for loan terms of less than a year. In other words, the APR increases rapidly the shorter the loan term. For example, the APR of typical short-term commercials loans will fluctuate widely based on only small differences in the term of a loan.
- TCC is more useful for comparing the absolute cost of a loan with a small business's expected return from investing the loan proceeds. A business that expects a short-term return on its investment would likely choose a loan with a shorter term and higher monthly payments to minimize TCC, even though that loan is likely to have a higher APR.
- Similarly, certain commercial financing products (such as a merchant cash advance) have a fixed fee but no fixed term and are paid back through a percentage of the borrower's receivables or sales. Solely focusing on the effective APR of such loans may not tell the whole story because if the business is successful, and pays the loan back faster, the term decreases and the effective APR increases.

For example, a 6-month loan will have a significantly higher APR than a 60-month loan, but the total dollar cost of the 6-month loan will be much lower than the 60-month loan. Of course, because it is paid back faster, the 6-month loan will have larger periodic payments and therefore the business should ensure it can handle the impact to cash flow. To illustrate these principles, consider the following hypothetical loans:

	Loan Amount	Loan Term	APR	Monthly Payment	TCC
Loan A	$10,000	5 years	19%	$259.41	***$5,564.33***
Loan B	$10,000	6 months	59%	$1916.67	***$1,500.00***

As the chart above makes clear, the amount of time the small business has to repay the loan has an important effect on APR – the shorter the loan term, the higher the rate (even if the total dollar cost of credit declines with a shorter loan term). As long as the small business can satisfy the larger monthly payments, a small business borrower would generally seek to minimize TCC by minimizing the loan term.

In conclusion, a loan with the lowest TCC will frequently be the preferred option of a small business. While APR is the primary metric for comparing consumer loans, and may provide useful information in connection with certain types of commercial credit, singular reliance on consumer disclosure standards like APR will not provide small business borrowers with the best or most complete information for comparing credit products. For these reasons, ETA cautions that APR is not be the silver-bullet many believe and encourages further discussion and outreach to small business borrowers, lenders, and industry groups to determine an appropriate disclosure standards.

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