Summary of Short-Term Finance Disclosure Testing for SBFA

Kingsley-Kleimann Group
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KINGSLEY-KLEIMANN GROUP

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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.
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- 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.
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- 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:

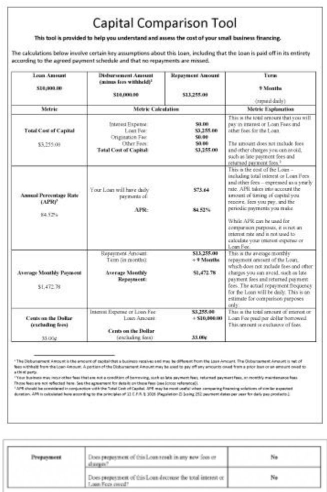
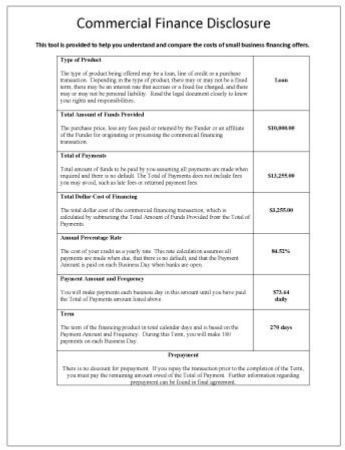
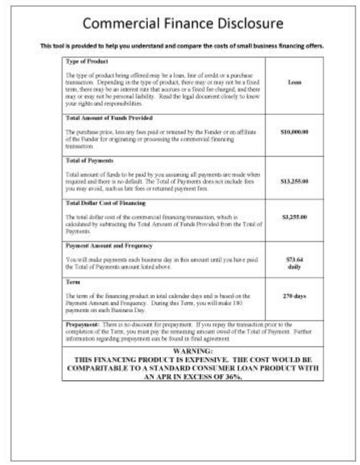
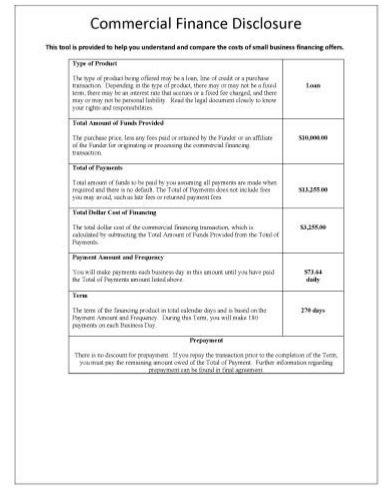
- 8 participants had experience with a Future Receivables Sale Agreement;
- 8 participants had experience with a product that requires daily or weekly payments;
- 8 participants had experience with a Business Loan or Security Agreement; and
- All participants had previously used one of the above products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

Test Structure

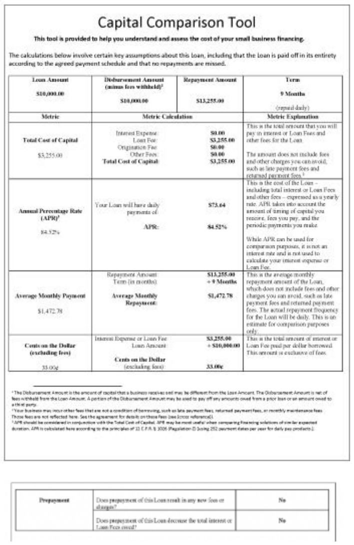
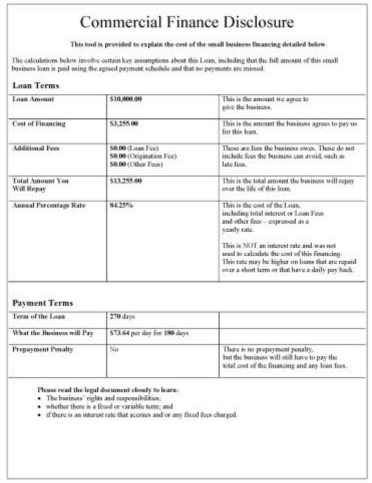
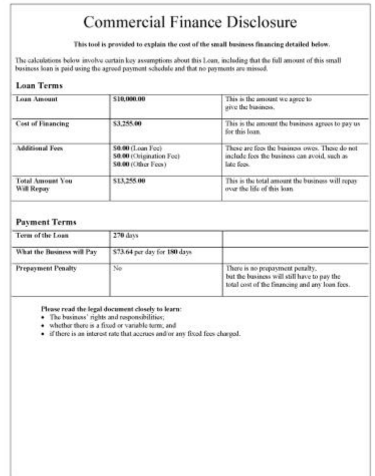
For each test, we used a one-on-one, think-aloud protocol with follow up cognitive questions. The testing used the following structure.

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.

Test Disclosure Designs – Round 2

Design 1. Capital Cost Comparison	Design 5. SBFA APR R2	Design 6. SBFA NO APR R2
 Capital Comparison Tool	 Commercial Finance Disclosure	 Commercial Finance Disclosure
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.

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.

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- **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.

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