

Consumer Finance Monitor (Season 4, Episode 43): A Close Look at the CFPB's Section 1071 Proposed Rule to Expand Data Collection and Reporting in the Small Business Lending Market: Part I

Speakers: Alan Kaplinsky, John Culhane, Lori Sommerfield and Heather Klein

Alan Kaplinsky:

Welcome to The Consumer Finance Monitor Podcast, where we explore important new developments pertaining to the consumer financial services industry. My name is Alan Kaplinsky. I am senior counsel at Ballard Spahr. I was formerly the head of the Consumer Financial Services Group at Ballard Spahr. Today, I'm going to be introducing for you part one of a two part podcast series that we are going to be presenting. This is based largely on a webcast that we did several weeks ago, and it pertains to a very controversial and I think what's going to be a contentious rule making being conducted by the CFPB in the small business lending area. Most of what the CFPB concentrates on is consumer lending. However, Dodd-Frank, which was enacted in 2010, contained a Section 1071, which amended the Equal Credit Opportunity Act to require financial institutions to collect and report certain data in connection with credit applications made by women owned or minority owned businesses and small businesses.

Alan Kaplinsky:

What we're going to be focusing on today is the notice of proposed rule making that was issued not long ago in a 1918 page document, so there's a lot of content and a lot of material to really explore during this program today and next week. What we're going to do today, the way we're dividing up the program, is that first going to turn to John Culhane, who's going to give a brief history of Section 1071 of Dodd-Frank. The reason for the CFPB's very likely delay in implementation of Section 1071, and the lawsuit that finally resulted, that prompted the CFPB to act under a court imposed deadline. So John's going to give us the very interesting background regarding this proposed rule.

Alan Kaplinsky:

We're then going to go to Lori Sommerfield and Heather Klein, two other lawyers at Ballard Spahr, and they're going to give an overview of the proposed rule, the particular areas of concern that people are focusing on, and how the data collection requirements different from what was outlined in a 2020 SBREFA proposal. SBREFA is the acronym for small business, it's called a consulting panel, which the CFPB was required to assemble so that CFPB could get the benefit of any input on a proposed rule from small businesses. The idea of course is that Congress didn't want federal agencies to enact, promulgate regulations that would be extremely difficult for small businesses to actually comply with. So we're going to do that. And that will be where we'll cut things off today.

Alan Kaplinsky:

Next week, we're going to be covering some additional areas, and let me just give you a very quick preview. I'll have on the program, Rich Andreano, who is the co-chair of our mortgage banking group at Ballard Spahr. And he is a recognized expert on the Home Mortgage Disclosure Act, or it's often referred to by the acronym of HMDA. And the Section 1071 of Dodd-Frank is largely based on HMDA, on reporting data collection and reporting requirements that are imposed on the mortgage banking industry. Except in this instance, 1071, we're dealing with small businesses. So Rich will be discussing that next week. Lori will be talking about a likely timeline for the issuance of a final rule and various compliance deadlines after a final rule gets issued. Rich will also be discussing privacy considerations for public reporting of small business data. And then in a lightning

round toward the end of next week's podcast, we're going to talk about the outlook for CFPB's supervision and enforcement, fair lending considerations, and risk mitigation recommendations.

Alan Kaplinsky:

So we've got a lot to cover, more than we could cover in just one podcast show, so we've elected to do it in two podcast shows. So with that introduction, I'm now turning the program over to John Culhane, who will give us an overview of the proposed regulation under Section 1071 of Dodd-Frank.

John Culhane:

Thanks, Alan. We've got lots to cover, so I'm going to jump right in with an overview of what we actually are going to cover. We're going to start out with a brief history of the section 1071 rule making, I think just to kind of explain how we got here and why it took so long, at least speculate about why it took so long. Then we'll segue into an overview of the proposed rule and we'll drill down on the key definitions, the data collection requirements, this unique firewall provision in the regulation, and financial institution reporting obligations. We'll talk about the likely timeline for the issuance of final rules and what the compliance deadlines might be. And then we'll really drill down on the mortgage banking issues and the relationship with this rule, between the rule and HMDA, and how things might be different here going forward.

John Culhane:

And we're going to end with sort of a joint discussion of the outlook for CFPB supervision and enforcement, fair lending considerations, and risk mitigation recommendations. And we'll all share in that discussion. So let's turn to the history of Section 1071. With apologies to Sam Cook, it's been a long, long time coming. Some of you may remember the missed opportunity for data collection, or possibly the intentionally missed opportunity for data collection on the part of the Federal Reserve Board when the Women's Business Ownership Act of 1988 was enacted on October 25, 1988. That act focused on small business in general, and in particular, small businesses owned and operated by women. And it amended the Equal Credit Opportunity Act to give a lot of flexibility to the federal reserve board to act in this area. But interestingly, it particularly specifically directed the Federal Reserve Board to require such records and other data relating to loans as maybe necessary to enforce compliance.

John Culhane:

The Federal Reserve Board passed. They chose just to require sort of the counterpart of consumer loan record keeping for business record keeping. And as you all know, I think they made distinctions on adverse action notices based on business size, but they didn't really go any further. And so it wasn't until 22 years later that we had the passage of Dodd-Frank on July 21, 2010. And we had this sort of interesting period between the passage of the act and the designated transfer date when the CFPB sort of officially appeared and was up and running. And in that interim period, the general counsel of the CFPB, Leonard Kennedy, issued a letter to financial institution CEOs, advising that Section 1071 is not self executing. It actually has a provision in it at the end. It's Section 1071-V, that says it takes effect on the designated transfer date, which would've been July 21, 2011. That would've really caused tremendous turmoil and havoc in the industry. Certainly, the CFPB wouldn't have been ready to move forward.

John Culhane:

And so General Counsel Kennedy issued this letter. The remarkable thing about this letter is that there are no citations in it at all. He read the legislative history and the statute, and concluded that nothing could happen until the CFPB issued rules. Well, nothing happened. Richard Cordray is appointed director, acting director, and then permanent director. And this regulatory action does appear in the CFPB's regulatory agenda, but it's a long-term action. And the regulatory agenda is in some respects a work of fiction in that agencies don't cue to what they say they're doing in the agenda. But on the other hand, it does give us some insight as to where they're putting their priorities. And this was not a priority for five years.

John Culhane:

In May 10 of 2017, the CFPB held a field hearing in Los Angeles on small business lending. And at the same time, they released a white paper on the key dimensions of the small business lending landscape. We'll talk about coverage as we move through the rule, but just an interesting point about this white paper is that it surveys the landscape and really concludes that it's the larger institutions that are the dominant players in this business, make most of the loans, and have most of the interactions with small businesses. Well, it gets on Cordray's agenda, they have the hearing in Los Angeles. They issue a white paper. They also announce that they're going to put a request for information, solicitation of comments published in The Federal Register. They do that. They extend the deadline. Things seem to be moving right along. The CFPB under Cordray issues a regulatory agenda indicating they've moved to the pre rule stage, and they're getting ready to go forward. And then what happens?

John Culhane:

Well, there is an election and a change of administrations, and priorities change. Nick Mulvaney comes in as director. His initial regulatory agenda still sort of has this as an active item, although it has it as an item for which there won't be much going on for a year or two, and that's his first pronouncement about the rule. And then in November, the rule goes into storage somewhere. It returns to being a long-term agency action, which means something they'll get to when they get to it. There's no discussion of what the next steps might be. There are no dates projected for further action. It's just sort of sitting in the water, not moving at all.

John Culhane:

Kathy Kraninger comes in, and she issues a regulatory, semi-annual regulatory agenda in May that sort of revives this. It at least indicates that the rule is in a pre rule stage, which means that the agency's thinking about it and starting to take some action. But about the same time that happens, the CFPB is sued by the California Community Reinvestment Coalition and other community groups joining that suit. And the CRC sues, asserting that the CFPB has violated the Administrative Procedures Act in two ways. There's a provision in the Administrative Procedures Act that allows any affected individual to sue to compel agency action that was unlawfully withdrawn or unreasonably detained. And certainly, the assertion is pretty straightforward here. The length of time that this has taken is an unreasonable length of time.

John Culhane:

And then coupled with that cause of action is an assertion that the CFPB acted in an arbitrary and capricious manner in not moving forward. Well, that litigation moves everything forward. The CFPB enters into a settlement with the CRD. The court approves a timeframe for moving forward, a SBREFA panel outlined to be released by September 15 of 2020, a panel to be convened within a month later, and then a panel report to be completed no later than 60 days later. And the CFPB meets all of those deadlines moving forward. Their feet are to the fire, and now they jump in and they move forward.

John Culhane:

We have another election and a transition. And we have David Uejio as the acting head of the CFPB. And we now have clear announcements that this is going to move forward and it does. On September 1, proposed rules are issued. They still haven't been published in The Federal Register. The reason for that is The Federal Register schedules these things so that they can get actually in the edition, and it's hard to get a 900 page visual here, a 900 page rule and an issue of The Federal Register, unless there's about nothing else going on. So it'll be out probably next couple of weeks, but hasn't come out yet.

John Culhane:

Covered financial institutions are going to have to collect and report data on small business credit applications, not just applications from women and minority owned small businesses, although there will be additional data collection there, annual reporting of data to the CFPB, and as I've alluded to, this really interesting firewall, where data has to be shielded from

underwriters and other persons involved in making any determination concerning the applicant's covered application. Let me stop there and turn it over to Lori, and we'll start drilling in on the rule.

Lori Sommerfield:

Thanks, John. My colleague, Heather Klein, and I are going to be providing an overview today of the notice of proposed rule making, and specifically the nuts and bolts of what is going to be required. I'm going to lead off with just sort of a brief overview of the proposed rule, and then segue into a discussion of some of the key definitions that are very pivotal for this rule making. Then I'm going to turn it over to Heather, and she's going to walk us through the data collection requirements because that's really where sort of the meat of the rule making lies.

Lori Sommerfield:

So with belaboring the point here, the proposed rule making notice is incredibly lengthy, clocks in at 918 pages. And as John mentioned, it still has not been published in The Federal Register. I think we're all looking forward to that day when it becomes a little less unwieldy to use. But in the meantime, the bureau has also concurrently issued a lengthy table of contents, a helpful summary of the rule that provides an overview of some of the key issues, as well as a chart containing the proposed data points, and a description of its methodology that it used for estimating institutional coverage, as well as market wide cost estimates. So these are all great resources to use as you seek to understand more about the notice of proposed rule making.

Lori Sommerfield:

So specifically, the NPRM would amend Regulation B by adding a new sub part B, which is entitled Small Business Lending Data Collection. And that would require cover financial institutions to collect and report to the CFPB a pretty broad set of data points for applications that relate to small business credit products. In fact, there are 23 data points that are required. And I guess it depends on how you count them, but we believe that 15 are required by Section 1071 of the Dodd-Frank Act, and another eight are what are called discretionary data points. Those are data points that the bureau was permitted to include in its discretion beyond those that are mandated by Section 1071.

Lori Sommerfield:

Covered financial institutions will be required to collect these data points on a calendar year basis, and then report them to the CFPB by June 1st of the following year. This will be done using a special portal that the CFPB plans to develop. And this is similar to the HMDA final rule, and we assume that the bureau chose June 1st so that it could provide some breathing room for HMDA reporters because as you know, HMDA laws have to be filed by March 1st of each year, so this at least gives a fourth month set of leeway here for the two various reporting deadlines.

Lori Sommerfield:

The CFPB then proposes to make that data publicly available on an annual basis by using a balancing test to determine whether the data should be released to the public. Whether some of the data should be deleted or modified will be subject to a balancing test that we will discuss later on in this presentation. The goal of Section 1071, as well as the notice of proposed rule making, is to enforce the federal fair lending laws, and also identify any community development or business development needs that women owned, minority owned, and small businesses face, chiefly by requiring collection of data on race, sex, and ethnicity of the principal owners of the business. And this goal of the rule making is also reiterated in acting director Uejio's statement that accompanied the release of the NPRM.

Lori Sommerfield:

Well, these are certainly laudable goals. Lenders are very concerned that this data is going to be used by the CFPB primarily for enforcement purposes. And think important, another concern is that if the CFPB chooses to take enforcement action, it also could refer any sort of pattern or practice to the US Department of Justice because it's required to do so under a co-op. And that's also true for the prudential regulators, by the way. The industry's also concerned about consumer advocacy groups that

might use this data, once it becomes publicly available, to file lawsuits, or class actions, or to publish policy papers that could conceivably misinterpret the data. So there's a host so risks here, so this is something to bear in mind as we have our discussion today.

Lori Sommerfield:

Needless to say, once this rule making is finalized, it's going to impose significant regulatory compliance and cost burdens, financial services lenders of all sizes offering credit to small business. And I think it's likely that the data collected under this rule is going to be used for enforcement purposes, not only by the CFPB, but by other federal and state regulators.

Lori Sommerfield:

So let's move on to some of the key definitions. These, as I mentioned, are really pretty critical in terms of how the regulation is going to play out once its finalized, and particularly concerning the types of institutions that are covered and have to collect and report data, as well as the types of business transactions that are covered and how small business is defined, among other things. So first of all, the definition of a covered financial institution, that's defined by the CFPB as a financial institution that originates at least 25 credit transactions, that would be covered credit transactions to small businesses in each of the two preceding calendar years.

Lori Sommerfield:

So in our view, this sets a pretty low bar, which signals to us that the CFPB is actually very interested in looking at potential discrimination in small business lending for loans that are originated by smaller lenders. As you'll recall, the HMDA rule actually began at the same threshold until Director Kraninger actually raised it to 100 mortgage loans. And perhaps the final rule will actually change this threshold, but for right now, it's set very low at 25 credit transactions.

Lori Sommerfield:

The bureau also notes in its preamble that this definition would apply to a wide variety of entities that engage in small business lending, so that would include entities like depository institutions, of course, online lenders, platform lenders, community development financial institutions, lenders involved in equipment and vehicle financing, commercial finance companies, nonprofit lenders, and even governmental lending entities. The CFPB is also proposing that creditors who are not covered financial institution could be allowed to voluntarily collect and report that data under certain circumstances, but we won't go into that topic today.

Lori Sommerfield:

Moving on to covered application, this proposed definition is largely consistent with existing regulation B's definition of application. The bureau's also proposing that certain circumstances would not be covered applications, even though they're considered applications for purposes of Reg B. Specifically, the bureau is proposing that a covered application would not include reevaluation requests, extension requests, or renewal requests on an existing business credit account, unless the request seeks additional credit amounts. It also would not include inquiries or prequalification requests. In terms of covered credit transactions, the bureau proposes to define that as a transaction that meets the definition of business credit under existing Reg B. Covered credit transactions would also include loans, lines of credit, credit cards, and merchant cash advances. It would also include any loans that are covered by HMDA.

Lori Sommerfield:

Next, let's turn to the definition of small business. Oh, and before I leave this topic on covered credit transactions, by the way, I should also mention what is not included. It would not include financing arrangements, whereby a business acquires goods or services from another business without making immediate payment, so this could be things like trade credit, or public utilities credit, securities credit, and incidental credit. It would also not include factoring, leases, consumer designated credit used for business purposes, and credit secured by certain investment properties. Finally, small business, the bureau is

proposing to define small business as an entity that has \$5 million or less in gross annual revenue for the preceding fiscal year. The CFPB proposes to define that term with reference to the definitions of business concern and small business concern, which are found in the Small Business Act and the SBA regulations.

Lori Sommerfield:

However, in lieu of using the SBA size standards for defining a small business concern, the bureau's proposed definition would look at whether the business had \$5 million or less in gross annual revenue for its preceding fiscal year. And the bureau does note in its preamble to the rule that it's seeking SBA approval for this alternate small business size standard under the Small Business Act. There are some additional key definitions here that I just wanted to share to make you aware of them as it relates to the definition of minority owned and women owned small businesses. And in each case, the business for which more than 50% of its ownership or control is held by one or more minority or women, minority individuals or women, and more than 50% of its net products or losses accrue to one or more of those female or minority individuals.

Lori Sommerfield:

My colleagues, Heather Klein and Rich Andreano and are going to be touching on each of these definitions, so I am going to save a more detailed discussion until then. And now, I'll turn it over to my colleague, Heather, to discuss data collection requirements.

Heather Klein:

Good afternoon, everybody. First, we'll talk about what I would call basic data points related to applications submissions, as basic as you can get in such an onerous data collection regime. And then we will be talking about data points related to the credit being applied for, followed by data points related to the credit decision. First, you have application data points, then data points regarding what the applicant applied for, data points relating to what the financial institution's decision was. We'll take a little bit of a deep dive into pricing information, which is one of the data points that are required related to the credit decision. Then we'll talk through the data points related to an applicant's business that are required, that are proposed to be required to be reported. And we'll wrap up with arguably the most important data points in the rule making, which are the minority or women's business status and the data points related to principal owners. And I'll wrap up my portion by showing you what the sample data collection form looks like for the protected demographic information data points, which are the data points related to minority owned business, women owned business, and the principal owner from race, ethnicity, and sex.

Heather Klein:

And then after we talk through what the sample form looks like from that appendix in the proposed rule making, we'll talk about some of what the expectations are in the proposed rule around the timing of collecting this information. So data points related to the application submission, so the CFPB's expectation is that these data points can be generated by the financial institution, so the unique application identifier would be an alphanumeric string. It need not be the same application number as is used in an institution system, but it needs to be able to be tied back to that applicant's file. The application date, that would be the date that the application is received by the financial institution, or the date that's shown on the paper or electronic application form, application method. So the options for application method are in person, telephone, online, or traditional US mail or similar courier service.

Heather Klein:

So in person includes virtual meetings. The key component of what the CFPB uses in person is that there is a video component to it, so it need not actually be physically in person, but there is a video component. And of course, the idea here being that perhaps there will be some kind of correlation between the method in which the application is received and the ultimate application outcome, or the credit that's offered or not offered. Telephone application would include other audio based methods, so long as it's without a video component. That would get classified as a telephone method. And the online method could include text message, as well as email, or any other online communication. And then that fourth category I

mentioned was traditional mail. And the CFPB has a comment that if the interaction involves the mail and online, then the institution would report the channel that it requested the principal owner's ethnicity, race, and sex.

Heather Klein:

And then the fourth thing here, the recipient of the application, here, the CFPB, is looking for whether the application was submitted directly to the financial institution or its affiliates, or whether it was submitted indirectly to a third party to the financial institution. What about data points related to the credit being applied for? So there are three key points here, credit type, which has a few sub categories, purpose of the credit, and the amount that's applied for. So let's walk through each of those. For the credit type, the CFPB has a few categories under credit products. I guess I'll just share some examples to highlight what this would include. For term loans or line of credit, the institution can designate whether it's secured or unsecured. There's of course fields for an MTA transaction or another sales based financing transaction. And then there are also fields for, quote, other form if the credit product is not provided by the applicant or not otherwise able to be determined.

Heather Klein:

Interestingly, there is a provision for if the financial institution counter offers a different kind of credit product, then there are some rules around what product gets reported, depending on whether the applicant accepted the counteroffer or not. For the types of guarantees, that could include a personal guarantee, state or federal government guarantee. These are types of guarantees that were obtained for an originated transaction, or would have been obtained if the transaction were originated. And then loan term, that won't be applicable in all instances, but where it is applicable, you have to be looking for a number of months. And they say that can be rounded up, rounded down, or if you count just the full month and not count partial months. And there are some provisions for ... There's an explanation in the rule making as to when the clock starts on that loan term.

Heather Klein:

So purpose of the credit, there's a list that the CFPB provides, and the institution can select up to three from the list, including an option for other, or NA if the purpose of the credit is indeterminate, such as for a credit card application, and then the amount applied for. There could be some variations here. What if there is a range specified? Well, the CFPB says to provide the midpoint. What if the applicant doesn't apply for a specific amount? Well, the CFPB says in that instance, the institution will underwrite ... If the institution underwrites for a specific amount, then that's the number that gets reported. And if there's no specific amount requested or underwritten, then the institution would report NA. In all of these, in most if not all of the fields that I'll discuss, there are options for other or inapplicable. But when the CFPB discusses using those options, it tends to note in the commentary that the institution has an obligation to make its best effort. Those are my words, not the bureau's words.

Heather Klein:

We'll talk more about the bureau's expectations in a little bit. But essentially, established procedures for having the best shot at getting the information from an applicant, so to the extent that an institution has a lot of fields that are incomplete, or NA, or coded as other without explanation, that might be something that the bureau will look a little bit more closely at. And before leaving this topic, I would also note that for the amount applied for, there are of course different rules to be followed if there is a firm offer of credit, or if there's a credit line increase that's requested, or some other additional credit amount that's requested. So there's a lot of detail here.

Heather Klein:

So next, we'll talk about the data points related to the credit decision. So what is the CFPB requesting in terms of the credit decision? They're requesting the action that is taken, the date of that action. And then there are various things that are required if the application is denied, or if it's approved, so we'll get to that towards the end of the slide. So action taken by the financial institution, there are a few options here. And one would look at these actions and say, "Well, in certain instances, more than

one option might apply." So the CFPB has tried to provide some illustration of when a denial would be noted instead of a withdrawal, for instance.

Heather Klein:

So I'll just walk through these. We'll try to do it pretty briefly to show what each of them means. So the denial would be used if the application was denied before it's withdrawn or closed for incompleteness. Likewise, if the application is withdrawn, it's considered withdrawn if it's expressly withdrawn before the institution makes its credit decision, or before it's denied for incompleteness. So there are a lot of technical timing issues here that some financial institutions might have some challenges addressing, depending on how their systems are currently set up.

Heather Klein:

Likewise, the action taken date, one might think that's a pretty straightforward field, but it actually differs based on what the action was that was taken. For example, for originated transactions, it could be the date that the loan closes, or the account opening date. The bureau also provides that it could be the disbursement date if that date is later than the other two dates. The bureau says that the financial institution should be consistent in its approach to reporting by establishing procedures for how to report the action taken dates for particular scenarios, products, or divisions. So there's going to have to be some mapping that goes on to get at the action taken date for each action taken.

Heather Klein:

The denial reasons, that field is going to look a lot like what people, folks are doing under Regulation C right now, if that applies to you. And if not, that's a good source to look to for how to report the denial reasons. Those are supposed to be up to four principle denial reasons. And then if the credit is approved, and that means that it's either approved and originated, or it's approved, but it's not accepted by the applicant, then the bureau is looking for the amount that's approved or originated, as well as pricing information. And in terms of amount, again, getting into the weeds on this, if multiple amounts are approved, then there is a provision for which amount gets reported, depending on whether or not the applicant accepts the credit. There's commentary around what happens if there's a counteroffer. And again, the amount would vary based on whether the applicant accepts the counteroffer or not.

Heather Klein:

And then if it's refinancing, then the amount that is reported would be approved or originated under the terms of the new debt obligation. I'm going to talk in more detail about the pricing information that could change in the proposed rule. Interest rate, so fixed, variable, if it's variable, then the bureau is looking for the margin, the index value, and the index name that is or would be applicable at origination. For origination charges, it would be ... And I should say for all of the following, for origination charges, broker fees, annual charges, and then the additional cost, for that pricing information, those are all going to be in dollar amounts, which could be a bit tricky, depending on the product that's being offered. So for origination charges, that would be all charges that are payable directly or indirectly by the applicant and imposed directly or indirectly by the financial institution, as an incident to or condition of the extension of credit.

Heather Klein:

And then of those origination charges, the bureau wants to know what the amount of the broker fees are that are paid by the applicant, whether that's directly to the broker or to a financial institution for delivery to a broker. So that may or may not be difficult to pull out, depending on the fee arrangements that a financial institution has with the third parties that are helping it source its loans. The initial annual charges, this like other things on this slide, may not be applicable to all transactions. So if it's not applicable, the financial institution would say, "Not applicable." But if it is applicable, those would be the non interest charges that are scheduled to be imposed over the first annual period of the transaction.

Heather Klein:

And there's a special provision for merchant cash advance or other sales based financing transactions because recognizing that some of these sales may not translate well to NCAs or similar transactions. So the bureau has supposed that those institutions report the dollar amount difference between the amount advanced and the amount to be repaid. I'm happy to help anybody who's in this industry think through the challenges in disclosing that amount because I think it's an interesting question.

Heather Klein:

And then for prepayment penalties, that would be two fields. So one, whether the financial institutions could have included a prepayment penalty under its policies and procedures applicable to the transaction, and then secondly, that's the general query of whether prepayment penalty could have been imposed, and secondly, whether or not there actually is a prepayment penalty in the applicant's agreement. And of course, by prepayment penalty, we're talking about a charge that's imposed for paying all or part of the transaction's principle before the due date.

Heather Klein:

Okay. Next up, data points related to the applicant's business. So some of these will be things that the institution asks the applicant directly. Some of these will be data points that get pulled in from other sources, like a tax return or elsewhere, that the financial institution can just pass through on its report to the bureau without needing to ask the applicant directly, but where any information here is asked of the applicant, and the financial institution does some kind of verification on it, then the institution would report the information as verified, not as received from the business.

Heather Klein:

So let's talk through what a few of these data points are, census track. This is interesting because the bureau has a bit of a waterfall of what address of location is used. So the first thing that they're looking for is the census track, the address or the location where the proceeds will be or would be principally applied. But if that's unknown, then you report the census track where the main office or the headquarters of the applicant is located. And if both of those are unknown, then we report another address or location associated with the applicant. So there is some provision for uncertainty here.

Heather Klein:

Gross annual revenue, this data point is getting at whether or not the business applicant is actually small business or not, covered by the financial institution's reporting obligation. And then there are some other topics that are requested that the financial institution report, including NICIS code, the number of workers that the business has, and time in business in years.

Heather Klein:

Okay. Let's move on to the hot button protected demographic information types of information. So of course, the key here is whether the applicant is a minority owned business or a woman owned business. And here, the financial institution reports this information out to the bureau. It needs to indicate whether the ownership status is being reported based on previously collected data. And we'll talk about that in a couple of minutes as to the requirements for when an institution can rely on prior data. When requesting the minority or woman owned business status, the financial institution has to disclose that the information is not required to be provided by the applicant, and that it cannot discriminate on the basis of the applicant's status as a minority or a woman owned business, or whether or not the applicant provides this information.

Heather Klein:

As for the data points related to principal owners, the rule making is of course asking for the ethnicity, race, and the sex of the applicant's principal owner. It's asking the financial institution to request that from the applicant. So there are some interesting little wrinkles here. And again, I'll just note that the financial institution and reporting out this data, the bureau needs to indicate whether it's being reported based on previously collected data. And again, the institution makes a disclosure to the applicant about being unable to discriminate based on this information, or based on whether the information is provided.

Heather Klein:

So with respect to the principal owner information, there is the opportunity, there is a requirement, I should say, that if the applicant does not itself report its ethnicity and race, and if the institution meets by video or in person with one or more of the principal owners, then there's an obligation for the institution to report based on visual observation or surname. That does not apply to the sex of the applicant's principal owners. With respect to sex, the principal owner, one or more principal owners would tell them that information themselves. And when we go to the sample form, we'll be able to see that they may self describe their sex in addition to, or instead of choosing male or female.

Heather Klein:

And in the rule making, the CFPB is seeking comment on whether, and if so how, the collection of the principal owner's sex should incorporate sexual orientation and gender identity. And in connection with requesting the ethnicity, race, and sex of an applicant's principal owner, the institution is required to report the number of principal owners.

Heather Klein:

So let's take a look at the sample data collection form. It's in two pages. And the important thing to note here is that the protected demographic information, which is the minority owned business status, the woman owned business status, and up to four principal owners' race, ethnicity, and sex. But that information needs to be collected separate from the other application information. And the commentary provides some examples of how to separate out the requests from the rest of the application information. But one of the key facets of the rule making is that there is the sample form that can be provided separate from the application itself.

Heather Klein:

I think I mentioned before, but in case I didn't, an important point about the protected demographic information is that the financial institution may not verify minority or woman owned business status that an applicant provides. And it may not verify the principal owner's ethnicity, race, or sex that the applicant provides. So that is different from the other business information that the financial institution is collecting from the applicant. And this is the second page of the proposed form. Of note here is that the ethnicity and race of the principal owners are being requested both in aggregate categories disaggregated categories. So it's a little bit hard to see on the screen, but the box for other, Hispanic, or Latino, the principal owner would print the origin of their ethnicity, for instance.

Heather Klein:

So the last topic that I'll cover before passing the baton back to Lori is the timing of data collection. If you are at a financial institution, and you are tasked with thinking about implementation of this proposed rule when it eventually becomes finalized, and Lori will talk more about the anticipated or our best guesses as to timeline, if you are thinking about implementation, one of the key things to think about is the procedures for collecting the applicant provided data because these procedures need to be targeted at collecting it in a timely manner that's reasonably designed to obtain a response.

Heather Klein:

So the commentary says that a financial institution may make more than one attempt to obtain a response, but it's not required to, that the procedures may vary based on the product and the lending model and the data type. And in addition, the commentary, I can't recall if it's in the commentary or the proposal rule itself, but a very important piece of this is that the institution must periodically reassess whether the procedures are reasonably designed to obtain a response, which is what I said earlier about using those fields of NA or other, I think the bureau will be looking at data from institutions and comparing institutions to each other to see response rates and the completeness of the data. And in fact, in discussing the procedures that an institution is required to have and maintain, the bureau provides as an example of this periodic assessment that the financial institutions look at other financial institutions' data and compare itself to its peers to see if its procedures are reasonably designed to obtain a response.

Heather Klein:

Okay, last point. This relates to reusing previously collected data on an applicant's business. So a financial institution is permitted to do this if the data were collected within the same calendar as the current application, and if the financial institution has no reason to believe that the data are inaccurate. And there, for instance, if the financial institution knows that the applicant underwent a change of ownership, then that would outdate some of the previously provided data. The key point here is that the reuse of previously collected data does not pertain to every single data point that we discussed. It only pertains to data on the applicant's business. This is paragraph 107A13 to 107A21. And it makes sense because we're not going to be reusing data on application number, or the type of credit product requested. We're going to be looking to see if an applicant applied for a credit card and a term loan within the same year. And if so, then we can go back, if it's within the same calendar year. And there's some discussion in the commentary as to how we measure calendar year.

Heather Klein:

If the application is submitted, but then decisioned a little bit later, how does that factor in? But there is some ability to go back and look at prior data, prior recent data, if it's not determined to be outdated. It should however have been a substantive response. So if the applicant says, "I don't want to provide this information," for their race, or sex, or ethnicity, that is considered a substantive response. If they just don't respond at all, then the financial institution is not able to use that non-response the next time that the applicant is applying for credit. Okay, thank you for bearing with me as I march through all the data points.

Alan Kaplinsky:

Well, we've reached the end of our part one of our podcast show on dealing with 1071 of Dodd-Frank. And of course, I want to thank our speakers and my colleagues, John Culhane, Lori Sommerfield, and Heather Klein, all of whom I thought did a superb job today. Want to remind you that next week, we'll be releasing part two of this podcast. And we'll be discussing the other issues that I mentioned at the beginning of our podcast show. And we'll be having join our party at that time, Rich Andreano, who is the co-chair of our mortgage banking group and an expert in the area of the Home Mortgage Disclosure Act, or HMDA.

Alan Kaplinsky:

Let me just remind all of you that our podcast show is a weekly show, except during December, when we take a couple of weeks off. It's available every Thursday, and you can find it on any platform where you obtain your podcasts on a regular basis. And it's also on our Ballard Spahr website. So thank you very much for listening today.