Consumer Finance Monitor (Season 4, Episode 44): A Close Look at the CFPB's Section 1071 Proposed Rule to Expand Data Collection and Reporting in the Small Business Lending Market: Part II

Speakers: Alan Kaplinsky, John Culhane, Lori Sommerfield, Richard Andreano 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. I'm Alan Kaplinsky, Senior Counsel at Ballard Spahr and the former past chair of our consumer financial services group. Today is part two of a podcast series that we began last week pertaining to Section 1071 of Dodd-Frank and, in particular, the notice of proposed rule making made by the CFPB in an attempt to implement Section 1071 of Dodd-Frank. Section 1071 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. There is a 90-day comment period for this proposed regulation that expires on January 6th of next year.

Alan Kaplinsky:

Last week, we had John Culhane, Lori Sommerfield, and Heather Klein cover a number of important areas. And certainly, if you haven't listened to that podcast, I'd urge you to do so. One also announced this podcast is based on a webinar that we did several weeks ago pertaining to the same subject. So today, the way we're going to proceed is we're going to begin with Lori Sommerfield. Lori is going to talk about the likely timeline for the issuance of a final rule and then compliance deadlines under the final rule when it gets issued. And then we will go to Rich Andreano who will talk about mortgage banking issues and the intersection with the HMDA Rule, Home Mortgage Disclosure Act rule. Then, Rich will discuss privacy considerations for public reporting of small business data. And then we will have a lightning round toward the end of our webcast, where we will discuss CFPB supervision and enforcement. We'll talk about fair lending considerations and risk mitigation recommendations. So with that introduction, I'm pleased to turn the program over to Lori.

Lori Sommerfield:

I'm going to quickly cover restrictions on employee access to data since this is sort of a unique provision of the Section 1071 rule making. So the CFPB proposes to implement Section 1071's requirement that a covered financial institution limit certain employee and officers access to certain data. And the bureau refers to this as the firewall provision. And it's important to note that this is a departure from existing Reg B, which doesn't have such a requirement. Under the proposed firewall provision, an employee or an officer of a covered financial institution, or the institution's affiliate, would be prohibited from accessing an applicant's response to inquiries that the covered institution makes pursuant to 1071 regarding, either whether the applicant is a minority or woman-owned business or regarding the race, sex, and ethnicity of principal owners if they are involved in making any determination regarding the application.

Lori Sommerfield:

And that's a very broad definition. Although the firewall provision will primarily impact underwriters and others within that a chain of command, it's certainly conceivable that it could be construed to be broader. For example, individuals in the fraud unit who are tasked with clearing identification verification, because that could impact the determination of how an application is decisioned. The CFPD does carve out an exception though, and that prohibition would not apply to an employee or an officer if the covered financial institution determines that it's not feasible to limit that individual's access to information and the covered institution provides a notice to the applicant regarding that access. The Bureau basically proposes some sample

language that covered financial institutions can use for that purpose. And it can either be provided to individual applicants, or it can be provided to a group of applicants up to, and including, all applicants, if that's easier for your internal processes.

Lori Sommerfield:

Next, let's talk about covered financial institution reporting obligations. As I previously mentioned, the Bureau is proposing that covered financial institutions be required to collect data on a calendar year basis and then report the data to the Bureau by June 1st of the next year. To accomplish this goal, the Bureau is planning to provide technical instructions for the submission of data in a filing instructions guide, as well as related materials. And this approach is similar to the approach that the CFPB took with Honda. I'm going to leave this publication and privacy issue alone, and I'm going to defer that to Rich Andreano to address. But I think the other important point here is that the Bureau proposes that the CFPB's publication of data through the portal, which will be made available to the general public, will satisfy a covered financial institution's statutory obligation to make the data available to the public upon request.

Lori Sommerfield:

So that is one way in which I think the CFPB has thought to reduce burden on institutions. And now we get, I guess, to the $64,000 question about what does the likely timeline look like for issuance of the final rule, as well as the expected compliance date? And we've had some internal discussions about this, and it's really hard to read the tea leaves here, but I would say that our money is more on earlier issuance of the final rule than later. Of course, there are some factors in play here, like the fact that there could be a lawsuit that seeks to basically state the issuance of the final rule. 2024 is coming up on another election year. But I would say on balance, we have to look at what the CFPB said in the rule and then just sort of think through what might be logical based on what we know of the political and the regulatory climate.

Lori Sommerfield:

So let me just kind of walk through our thinking on this. So first of all, the CFPB indicates that the final rule would become effective 90 days after publication in the Federal Register, but the compliance wouldn't be required until 18 months after publication. So that stands in contrast to the Sabri file outline in which the CFPB said the compliance would be required within two years. So they've already shortened it. Of course, we expect that the CFPB is going to receive a large volume of comment letters, which they are then going to have to consider and resolve. And that's going to be a huge undertaking, we would surmise.

Lori Sommerfield:

Also, as part of the stipulated settlement that the CF PB entered into for the two consumer advocacy groups and the two individual plaintiffs, the CFPB is going to have to go back and probably negotiate with the plaintiffs and the court about the data issuance of a final rule. So we also think that it's unlikely that the CFPB is going to require midyear compliance. Our guess is the Bureau is going to try to start compliance at the beginning of the year. And assuming that they'd want to get this rule issued sooner rather than later before there's a change in administration, our best guess is that the likely scenario is that the CFPB would try to shoot to have it published by June 1st of 2022. As you know, it's taking forever for the notice of proposal making to be published in the Federal Register because they need to allot almost an entire issue to this proposal. So assuming it's going to take another month to get published, that would then put the publication date out at about July 1st. So in order to factor in that 18-month timeline, and if the Bureau would want to try to have the rule be effective by January 1st of 2024, they would have to try to get it published by about July 1st of 2022.

Lori Sommerfield:

So there's a lot of variables here and, certainly, if the CFPB rushes out with a final rule and doesn't sufficiently resolve all the industry satisfaction, that could result in another lawsuit that could delay the rule. It's also possible that the 2024 election year could factor into how soon the Bureau goes about issuing it, but we really don't expect the Biden Administration to back off on fair lending matters and, if anything, would embrace issuance of rule sooner rather than later so that the bureau can begin enforcing it. So I guess the bottom line here is that it's conceivable that compliance could be required as early as 2024,

although it could be later. And although that seems like a long time away, you really should begin sort of keeping that top of mind as we move forward that that is one of the scenarios that could play out and start working toward planning for compliance now. We'll talk about that a bit later.

Lori Sommerfield:

I also wanted to just mention that the Bureau has also proposed a couple of transitional provisions that would allow covered financial institutions to begin collecting information about the minority-owned or women-owned business status, as well as the race, ethnicity, and sex of principal business owners' information prior to the compliance date. So that would be in that window between the effective date and the compliance date. There's also a transitional provision that would permit financial institutions to use either the two calendar years that immediately proceed the effective date or the second and third years preceding the compliance date to determine coverage. So that's something that you might want to look into a little bit more closely. With that, I am going to turn it over to Rich to share with us his knowledge about the intersections here with mortgage banking issues and the Hunter Rule.

Richard Andreano:

Thank you, Lori, and everyone. First, what I'd like to address is something the Bureau decided would not be reported as small business lending. And that's the concept of investment property. We know for property is truly an investment property, it is carved out a lot of the consumer financial services laws. However, business purpose loans are subject to a call-up. And that raised the issue under the small business lending data collection regime, what would the bureau do? What they decided to do is not include an extension of credit that secured by a wonderful family dwelling that the applicant or one or more of the applicant principal owners does not or will not occupy. Now, again, drill down a little bit on that. What's an investment property? "If the applicant," here I quote, "or one or more of the applicant's principle owners does not or will not occupy." So it's clear if none of them occupy it, it's an investment property.

Richard Andreano:

The way it's drafted is peculiar though. What if there are several principle owners and one of them occupies it? I think they need to clarify that. I just think there's a little bad drafting. So obviously, in comments, we'll ask for some clarification. Now, assuming qualifies no one's going to occupy it, so it's pretty clear we have an investment property, that will apply both property that people intend to rent out or property that people intend to acquire and fix and flip. So those would both be investment properties. They will not be covered. So that is one helpful thing that we don't have to worry about in the mortgage side of this rule.

Richard Andreano:

Now, let's do some compare and contrast with HMDA. Clearly, the Bureau looked to HMDA, and the approach you took with the October 2015, major revisions of the HMDA rule, which resulted in the creation of the HMDA portal, which the Bureau intends to now duplicate for the small business lending application for coming up with a rule. Again, I think this is important. It was mentioned before, they picked the trigger as at least 25 covered transactions in the past two years. And that was the October 2015 HMDA trigger which was changed middle of last year to 100. I think the fact that the Bureau changed the HMDA trigger from 25 to 100, yet proposed 25 here, signals that they probably really intend to go forward with that number. And they're not viewing this as an apples to apples comparison with the HMDA rule. Obviously, that's something the industry will want to comment on about the burdens of requiring lending at such low level to be subject to this extensive data collection and reporting requirement. Now, we'll have a portal. So the Bureau has to create this portal. That was an issue with the HMDA rule as the lending industry, the vendors for the loan origination systems, were trying to design their software to provide for the collection of reporting, but they were waiting for the Bureau to design the portal, because the software they designed had to be able to speak to the portal.

Richard Andreano:

So that's something that will have to be done. And the key, as it was mentioned before, there'll be a filing instruction guide. That is what's really needed. You can't figure out how to compile the information from the proposed rule itself. You have to go, same as with HMDA, to a filing instructions guide, which is hundreds of pages long, and drills down to very minute level of detail to figure out how the data has to be programmed and what codes are used for what different responses from the applicant. So that'll be very important.

Richard Andreano:

Mentioned before, the Bureau may delete some information for privacy reasons. It's provided for in Section 1071. I'll go into that a bit more. And again, as mentioned, similar to HMDA, where before, you used to have your HMDA data available in your main office and certain branch offices, the Bureau has switched that. While you provide notices of the data availability, but the data availability is now on the Bureau's website. They proposed the same approach here. So that was one thing that is helpful.

Richard Andreano:

Now about the publicly-available data. Let's go over what happened there in the HMDA data. Don't believe any statements from the Bureau indicating a concern about privacy. Why do I say that? One of the first things Kathy Kraninger did, when she became director, was actually finalize what was mostly the proposed former Director Cordray's version of proposed public guidance for the release of public data. Why did she have to do it? It was January 2019, the 2018 data had been collected and was about to be reported. They had to issue you the guidance. So she pretty much went ahead and issued what the prior administration had developed. But at the time, she said she was going to revisit in rule making. And in fact, the Bureau, under Director Kraninger, was gearing up to do a rule making. Now, if you want to see what they really did, look at our Consumer Finance Monitor blog on the internet.

Richard Andreano:

The January 8th, 2019 date has a blog post that summarizes what the Bureau did and how it released data. Pretty clear when you read that they went to the side of disclosure rather than privacy. I, in fact, entitled the article that they had adopted an off-balanced approach as a little plug at their comment that they were using a balancing test. They might have had a balance, but they had their thumb on the side of disclosure on that part of the scale. Here's what they said about it. This is almost the exact statement they made in terms of the HMDA balancing test, yet when it came down to brass tacks, they are disclosing most of the information. And interestingly, and this could lead to a lawsuit, in the preamble, they go through each data item point by point and give their preliminary thoughts as to whether they think they would release it or release it in a modified context. What they plan to do is, after they get the first year of the 1071 inflation, they're going to analyze it further. And without any re-proposal, just go to final public guidance. That may well trigger a lawsuit. I thought the public guidance under HMDA was a rule making. I think whatever they do here is rulemaking as well, no matter what they say. So this is an area that could also cause litigation with regard to this rule.

Richard Andreano:

Now, let's take a look at the demographic information similar, similar, but not identical, to HMDA. And one of the things is... Some of this will be repeated, but it's important. Key here, they must ask about the ethnicity, race, and sex of the applicant or the principal owners on a form that's separate from the application. It could be a separate form or it can be done as the application form. We know the Fannie-Freddie uniform residential loan application. There it is in the application form. So we have that. This is different. It must be separate. Obviously, this would probably triggered by the need for the firewall. They want the data to be separate. Key here difference. We know now, if an applicant in the HMDA world does not provide ethnicity, race, or sex information and you see them either through a video hookup or in person, you have to record that based on visual observation or surname.

Richard Andreano:

In this case, if you, again, are seeing the applicant and video hookup or in person, and they don't provide the ethnicity, race or sex, you must record the ethnicity or race, but not the sex, based on visual observation or survey. Query whether this will work itself into the HMDA world. We'll have to see about that. Interesting, if there are several principal owners and they provide the information for say, only one, they give you the ethnicity, race, and sex information for only one, you're done. You don't collect anymore. What if, for one principal owner, and there are three others, they just provide the ethnicity, but not the race or the sex, again, you're done. Very different from HMDA. So while the policies and procedures will be somewhat similar, they will be different. So there'll be different training and policies and procedures required here.

Richard Andreano:

Also, a concept foreign to HMDA, the use of previously-collected data as was coverage recently. That is not a HMDA concept. That is a concept that they're proposing here. Also, the way the information's collected. In the 2015 HMDA rule, what they did for the first time, the Bureau, is they created subcategories for the Hispanic or Latino ethnicity subcategories in the meta free form field. The same for the Asian race and the same for the native Hawaiian, other Pacific Islander race. White and Black, or African American, just had the aggregate categories.

Richard Andreano:

What happened in between then and now? The 2020 Census. In the 2020 Census, they included, in the questionnaire, the ability for either a white person responding or a Black or African person responding to indicate a subcategory. They didn't have check boxes, but you could write in a free form field. What they're proposing now, as Heather reviewed in that form, is there would be the specific categories that are on the screen, and those would be check boxes. And then there would be an other checkbox with some suggestions, in a free form field, that the applicant can complete. They didn't do that for White applicants. They just did it for Black or African-American applicants and, as we noted, different approach to the sex request here where male, female would exist, but then there would be a third. I prefer to self-identify as blank.

Richard Andreano:

HMDA, it's just male or female. The applicant can check both. And then the institution would indicate they did check both, but they don't have this. This is clearly triggered by the more recent focus. Heather mentioned the Supreme Court case, in March rather of this year, the Bureau issued the co-interpretation indicating that sexual orientation or gender identity were prohibited bases of discrimination under Cohen based on the prohibition to discriminate on sex. They're clearly focusing on this. They're also taking a variety of different approaches, even perhaps not asking male or female, just ask the applicant to fill in what you identify as. So this is an area where I think we may see changes in HMDA as well. And it's obviously based on current demographic, friends, and thinking by the regulators.

Richard Andreano:

Now, it's a lot of data. It's a brand new scheme. Are they going to cut us some slack? They don't indicate they're going to cut us any slack data of the gate. We already know the error thresholds to resubmit HMDA data are very low. They are at the top. This is right out of the HMDA examination guide. And the difference with HMDA is you first do an initial sample threshold. If you meet that threshold, then you do the full threshold and you could see re-submission someone with over 100,000, boy, you look at 61. If you have four that are wrong, 2.5% you re-submit. Wow, that's tough. The industry doesn't like that, but the Bureau hasn't budged. They're proposing to use the same thresholds for this rule. And it's the brand-new rule and no indication that they're going to be lenient the first year or two.

Richard Andreano:

This is something where realistically, they need to be lenient the first year or two because we have a platform that doesn't exist. We are going to need software that doesn't exist, policies and procedures that don't exist, training that doesn't exist. This is a big lift. This is a big lift for the industry. And common sense says, "Okay, here's what we're going to use going forward. First

year or two, we'll be a little more lenient. We want to make sure you get the data right." That's what they sort of did with HMDA. They first beat people up, get it right, get it right, get it right, because good analysis doesn't come from bad data. So they're first going to really focus on getting this data right. Now, with that, just wanted to give a quick comparison, kind of move into a lightning round, if you will, of some high-level issues or important issues.

John Culhane:

So thanks Rich for introducing us to the lightning round. So in the next 10 minutes, we're going to try to squeeze in some observations on enforcement, fair lending considerations, risk mitigation recommendations. But I see a recurring question has been, is it a business loan? And just to get that out of the way, the test in the regulation is a primary purpose test. It's the same test that exists now under regulation B. In fact, it references the reg B test. There's more commentary on the primary purpose test in regulation Z, which may be helpful, but that's the rule. And leases are not credit, so more motor vehicle leases are not sold and fintechs are covered. In fact, the CFPB estimated how many it would probably be swept in into the rule. And it's the provision of the rule deals with the impact on small businesses. So with that, let's just jump in. Let's start with Rich. How do you think the CFPB is going to proceed here to supervising and enforce?

Richard Andreano:

Obviously, by proposing the error threshold, that's the same as the HMDA to threshold, which is very low for a regulatory scheme that doesn't even exist yet. They clearly intend this to be important. This is fair lending. Fair lending, in the lending area, is at the top of their list. They view this as an adjunct for that. The Biden administration has clearly signaled that fair lending is important to it. So this is going to get a lot of focus. What that means is now, don't think about the 18-month client. Now, you need to start devoting resources to get people up to speed on this rule. And obviously, you have to work with your systems providers as to when they're going to have the software available, but this is something to start talking with them now and letting them know, you may want it sooner than the compliance date because you can voluntarily collect the information once we get to that 90-day effective date. And you may want to do a little kicking of the tires before you have to report that information to the government.

Lori Sommerfield:

I think further to what Rich said though, I mean, I think the CFPB is going to focus first on data accuracy, and then they're going to move to enforcement, but there's probably not going to be a long period of leniency, as Rich mentioned in his prior segment. So it's probably going to be a short transition from achieving data accuracy to the CFPB actually bringing enforcement actions against covered financial institutions.

John Culhane:

Lori, you think the prudential regulators in the FTC will jump in here as well?

Lori Sommerfield:

I absolutely do. Certainly, the CFPB has primary jurisdiction for administering and enforcing ECOA and reg B, but so do the prudential regulators and the FTC. They also have responsibility for enforcing ECOA. So I think that they will indeed start looking at and mining that small business data to enforce the rule. But I really think the greatest fear here are the referrals to DOJ for pattern or practice discrimination in small business lending. I also think there's probably a risk, in the second part of this question where we talk about state attorneys general and state banking agencies, that some of the more activist state attorneys general will also seek to enforce the rule. And some of the state banking agencies, like the California Department of Financial Protection and Innovation, are already looking at what ways to scrutinize small business data. For example, the California DFPI recently had a UDAP rule making around that topic. So I think any of these regulators are probably fair game to be in the mix on enforcing this rule once it's finalized.

John Culhane:

Thanks, Lori. We sort of have a question here about the expectations concerning consumer advocacy groups. And I saw in the Q and A box that one of our attendees asked "So what's in this for the CRC, and why did they sue? Kathy Kraninger was then the head of the CFPB. And why did they bring that lawsuit?" They are very clear in the complaint about why they brought that lawsuit. They want to accomplish... I'm going to just quote from the complaint. "CRC seeks to accomplish its mission by negotiating agreements with lenders to increase lending to and investments in women-owned, minority-owned, and small businesses by publishing evidence-based reports to educate its members, policy makers, and the public about areas of need and ways to promote credit access." They don't consider the data they have access to at present to be fully adequate to that purpose. And so you have to expect that they, and all of the other consumer groups, are going to be going through this data very carefully. There will be shame lists that will be published, and there will probably be some consumer-initiated actions as well. Rich, let's go back to you. What are the key operational issues? You reference that in sort of gearing up for compliance. Could you say a little bit more about that?

Richard Andreano:

Right. And again, this will be important in developing software, whether internally or externally, to be able... And the policies and procedures, to be able to gather the information in a compliant manner and then to be able to format it in the way that will be necessary to submit it. One thing I know with the HMDA portal, the functionality the Bureau built into it's very capable. Before actually submitting your information, you could upload it and the system will let you know if the loan application registered data is formatted correctly. I hope they build that same functionality into the small business portal because that really cut down on the number of areas and saved both the industry and the Bureau a lot of time. But this is both a operational and a technology heavy lift, as we saw with the October 15 rule. And we're going to be waiting for the Bureau to develop their portal. And one thing they found out is kind of the comeuppance for the Trip rule. When the industry had to do all the programming, the Bureau had to do a lot of programming with the HMDA portal and they found out it took a lot longer than they thought. So unfortunately, that portal may not be ready as soon as we would like so our vendors could start mapping data to that portal.

John Culhane:

So what are the implications now for fair lending risk management programs? What type of enhancements should be made?

Lori Sommerfield:

I'll take that one, John. And Rich is welcome to chime in here. But I think one of the key things that fair lending officers need to be in doing is educating your small business lenders about this role. I think there's been denial in some quarters that this was actually going to happen because the timeline kept getting pushed out, but this is happening now. So it's important to start looking at your business operations. It's important to reexamine your fair lending risk management program. And as Rich mentioned, also, this is a big focus on systems. So start looking at your application forms and the data that you're currently collecting for small business lending and determine what needs to be modified to comply with a proposed rule. Also, in terms of testing and monitoring, start looking at the data that you've got and begin doing some testing now, as well as once the compliance period begins following the effective date of the rule after the final rule is issued.

Lori Sommerfield:

For testing and monitoring, we recommend reviewing small business lending, credit decision, and pricing policies and procedures, see if those need to be adjusted. Take a look at your small business loan, judgemental underwriting decisions, and make sure that they're consistent. And for small business lenders that have a sufficient volume of loans, we recommend that you start doing fair lending regression analysis of your portfolio using available data, and proxies as needed, as an initial step toward compliance. It's very important, though, that you do this in conjunction with a qualified econometrician or statistician and conduct those analyses under attorney-client privilege to protect the results. This is where your legal counsel becomes your best friend if you are in the business. So these are really important steps that small business lenders need to take now to get into compliance over the next two- or three-year time frame.

John Culhane:

Heather, do you have anything you'd like to add on any of these questions?

Heather Klein:

Just that I think that we cannot underestimate the use of the data by the consumer advocacy groups. I think that, especially at the state level where CDGs and bank agencies might not have a deep bench at their lending expertise or might not have the resources to conduct some of these analyses, they're going to be looking for the consumer groups to see what they're finding and they'll take action based on their results.

John Culhane:

Okay, Alan, can I turn it back to you?

Alan Kaplinsky:

Well, I want to thank Lori Sommerfield, Rich Andreano, John Culhane for doing a superb job in dealing with all the issues we've dealt with today in what is part two of our two-part series pertaining to the notice of proposed rule making issued by the CFPB under Section 1071 of Dodd-Frank. I want to remind all you of the fact that our podcast show is a weekly show where we release a new episode every Thursday, except during the month of December when we take a couple of weeks off. I want to also remind all of you, if you're not already subscribed to our blog, which also goes by the same name as our podcast show, Consumer Finance Monitor, you should log on to our blog and register and subscribe for it. We typically issue at least one and sometimes more than one article each day. A lot of content on there. We've been doing the blog for over 10 years, and we really cover the waterfront, all aspects of the consumer financial services legal world. And finally, I want to thank all of our listeners today, our loyal listeners, who have downloaded our show, and want to thank you for your loyalty and for listening to our show. Thank you again.