

Consumer Finance Monitor (Season 6, Episode 22): The Consumer Financial Protection Bureau's Final Section 1071 Rule on Small Business Data Collection: What You Need to Know, Part I

Speakers: Alan Kaplinsky, Rich Andreano, and John Culhane

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm.

I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, which also goes by the name of Consumer Finance Monitor.

We've hosted our blog since 2011 when the CFPB became operational, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com.

And if you like our podcast show today, please let us know about it. Leave us a review on Apple Podcasts, Google, Spotify, or wherever you access your podcast shows. Also, please let us know if you have ideas for other topics that we should consider covering or speakers that we should consider as guests on our show. Today's podcast show as well as the podcast show that we will release next week is a repurposing of a webinar that we did on April 17th about the CFPB's final Section 1071 rule on small business data collection.

What you need to know. The CFPB issued its long-awaited final rule 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 small businesses, including women or minority-owned small businesses.

Although the final rule will be effective 90 days after it is published in the Federal Register, it contains a tiered compliance date schedule with an earliest compliance date of October 1st, 2024 for financial institutions that originate the most covered credit transactions and a later compliance date for institutions with lower transaction volumes.

We will take a close look at the final rules' data collection requirements and consider their implications for fair lending risk management. The topics that we're going to cover in both today and next week are ... Which financial institutions are covered? Who is a small business? What's a covered application? Which types of credit transactions are covered? What are the data points that must be collected and reported by financial institutions? What are the restrictions on employee and officer access to data?

What are the compliance dates? What does the CFPB's grace period policy statement provide? What's the outlook for CFPB supervision and enforcement of the final rule, including the CFPB statement on supervisory and enforcement practices? What operational issues should be considered in implementing the final rule? What are the final rule's implications for fair lending risk management? What are the similarities to and differences from the Home Mortgage Disclosure Act data collection and reporting requirements?

For our program today, part one, I'm joined by my colleagues Rich Andreano and John Culhane. You already are familiar with my colleagues, Rich and John. Just very briefly, Rich is the practice group leader of our mortgage banking group and he's co-chair of our fair lending team in our Washington DC office. He is without a doubt one of the leading experts in the country on the Home Mortgage Disclosure Act, which is basically the statute upon which Section 1071 of Dodd-Frank was based.

And so, the skillset that Rich acquired over many years on the Home Mortgage Disclosure Act, or HMDA, has been on the books and can be brought to bear on what we are facing with section 1070 of Dodd-Frank. John Culhane is a regular on our webinars and our podcasts and has practiced with me for more years than I would like to remember. But John is also going to be joining us.

I'm going to now turn the program over to John. We'll talk about the definitions of financial institutions, small business, and covered application. And then, we'll go directly to Rich, who will talk about the data points that you need to collect and the restrictions on employee and officer access to data.

John Culhane:

Thanks, Alan. So I'm going to talk about what we consider to be the key definitions in the regulation. The definitions of covered application, covered credit transaction, covered financial institution, and then, obviously, small business. But let's start with covered application. The CFPB has basically repeated the standard definition of an application under old regulation B, which I guess, is now subpart A of regulation B.

It's an oral or written request for a covered credit transaction made in accordance with the procedures used by the financial institution for the type of credit requested. Now, the CFPB acknowledged that this test of what's an application, where you're looking at the procedures used and drilling down on the actual practices, could result in a fair amount of variation in reporting based on the practices of the financial institution.

They felt it was important to stick with this definition, because it is the definition that already exists in regulation B. It's the one that the industry is familiar with, and they felt that they could address any discrepancies or variations that they identified in reporting process or in examinations, by looking at an institution's peers to see how they're handling applications.

Now, there's really an important concept here. And that is that, "Applications," include applications that are incomplete at the time of receipt. Or even applications that are later withdrawn without there being a decision on the application. In that regard, the CFPB has in mind this tipping-point concept, which is that ... At some point, in the collection of data from an applicant, enough data has been received that the application is deemed to be submitted and moves into a processing point for a decision or for further evaluation for requests for information.

That's a pretty important concept and you want to be sure that you look at your own practices in that regard. What's excluded? Requests for reevaluation or an extension or renewal of an existing credit account, unless the applicant specifically requests additional credit or a line increase. But all requests for refinancing are included. Inquiries and prequalification requests are treated a little differently here. They are never applications. Even if they might subsequently turn into applications for credit under the standard definitions and commentary in regulation B.

Solicitations, firm offers of credit that result from pre-screening. Other evaluations that are done internally such as evaluations for additional credit or a line increase that are initiated by the financial institution do not count as applications. Applications are things submitted by the applicant to the covered financial institution for a covered credit transaction. There are a number of comments addressing different scenarios that can come up in this, in determining whether you have one application or multiple applications. I'd recommend that everybody look at the commentary carefully.

Let's move on and talk about a covered credit transaction. This is a lot like what the proposed rule said. It's basically everything. All extensions of business credit unless expressly excluded. There were numerous commenters that argued that merchant cash advances should be excluded because they aren't credit. The CFPB obviously doesn't like merchant cash advances. They went out of their way to emphasize the high use of merchant cash advances among minority-owned businesses.

They repeated their assertion that there are lots of problems in the way merchant cash advances are provided. They felt that argued for gathering even more data. And then, basically, the CFPB just feels that they all constitute credit. Therein, their business credit. Even agricultural credit is included. And that's in large part because of concerns about minority farmers and how they're treated and a GAO report about that. Excluded. Trade credit, HMDA-reportable transactions, insurance premium financing, which is new.

Things that are already excluded under regulation B. Public utilities, securities, incidental credit. But also excluded are factoring, so that's an accounts receivable purchase transaction. Consumer-designated credit. That's credit that the institution

treats as being extended primarily for personal family or household purposes. Even if it might be used for business or agricultural purposes. And then, purchases are generally excluded, but keep in mind that the CFPB views indirect lending with captive finance companies and independent finance companies as institutions that are participating in covered credit transactions.

When we're talking about purchases here, we're really talking about transactions that occur sometime after origination. Rather than, in general terms, in pursuant to an advanced commitment as with a captive finance company or an independent finance company. How about financial institutions? This is a broad definition. Just about every entity is a financial institution. Banks, savings associations, credit unions, online lenders, platform lenders, community development financial institutions, farm credit system lenders.

Lenders involved in equipment and vehicle financing. As I mentioned, captive finance companies and independents. Commercial finance companies, nonprofits, even governmental entities. All financial institutions. Financial institutions are covered. If they originate at least 100 covered credit transactions for small businesses in each of the two preceding calendar years. It's originations that count, not applications. Important to focus on that here.

The CFPB really was reluctant to grant any exclusions here, and in fact, didn't really grant any. Only entities that fall below the activity-based threshold are excluded. There are no categorical exclusions. There were a lot of arguments by commenters that government lenders, nonprofit lenders, and the likes should be excluded. The only thing that would get an entity excluded would be if its activity is occurring outside of the United States. That doesn't count. There is no exclusion for the paycheck protection program. A bit of a moot point. But more importantly, for any future government programs that might come into existence, all of those will count.

So that's a financial institution. What's a small business? Well, we're using the SBA definition of a small business concern here. And that's going to be a business entity organized for profit. It has a place of business located in the United States. It operates primarily in the United States or makes a significant contribution to the US economy. Probably, not going to run into that too much. And then, the threshold test is the amount of gross annual revenue that this entity has.

If it had \$5 million or less in gross annual revenue for the preceding fiscal year, then it's a small business. Importantly, financial institutions can rely on the applicant's representations regarding gross annual revenue. That may or may not include affiliate revenue. I think there's going to be less flexibility on that as we move forward, if the CFPB concludes that financial institutions are going out of their way to count affiliate revenue in order to get over this threshold and avoid reporting. But for now, it may or may not include affiliate revenue.

But if you verify data, if you actually look at the revenue and review that, you have to count the data you verified. And if you get updated data from the applicant, you have to include that. What's excluded from the definition of a small business? Very little. Foreign businesses. Nonprofit organizations. Governmental entities as recipients, not as lenders. Let me stop here and pass the baton on to Rich to talk about the real meat of this data collection.

Rich Andreano:

Thank you, John. What you're going to do here is similar ... For those who are familiar with HMDA, a lot of this will be similar. There are a lot of similarities, but there also are differences. That's where I see some compliance issues perhaps arising, when people apply HMDA approaches to this rule. That's not going to work in all cases. But similar to HMDA, where you have a loan application render. Here in the end, you'll have a small business lender application register, that will be in electronic form eventually, and submitted to the bureau as is HMDA data through a portal that the bureau will have.

Now, the rule has a lot of information on how you file, but as is the case with HMDA, the real source of the key information is the Filing Instructions Guide. They have issued one for those who must file in 2024. This is a guide that will be updated each year. This really is something that both your compliance people and your tech people need to look at, because it really gets into what codes are used for the different reporting, where there are free-form text fields, the size of the fields and all of that. So it's really important programming.

Now, one difference from HMDA is purchases are not reported. You would report the origination of a covered small business loan, but you would not record the purchase of a small business flow. Now, let's get into the actual data points. Just like

HMDA, there'll be a unique application identifier. And by unique, it is unique. No two applications can have the same identifier. That identifier will start out with your company's legal identity identifier.

This is alphanumeric. No symbols or anything allowed. It's just purely alphanumeric. Similar to HMDA there. You could assign that identifier at any time before reporting, so it doesn't have to be assigned at the time of app. They gave some flexibility there. The application date. They followed HMDA here. It's the date you or an affiliate received the application or the date shown on the application. Your choice. Pick one. And it's recommended that you're consistent in what you pick.

The application comes in through a third-party. You have a third alternative of the date that third-party received the application. Application method. In-person. In-person includes electronic with a video component, so you could see the applicant. Then, there is phone. Online is pretty much any other electronic method that's just text-based. No video component included. And then, regular mail.

The application recipient. What they're looking for here ... Did you or your affiliate receive the application directly? Or did it come through a third-party? Also, similar to HMDA. Those familiar will see a lot of this is very similar. Now, data points related to the credit being applied for. Here's where we get into what it is the entity is looking for. Credit type. Now, there is credit product. There are 10 categories specified in the Filing Instruction Guide and you would pick from those.

If the type of credit is not in one of those categories, you would designate, "Other," and then in a free-form text field, indicate what that other credit in fact is. Type of guarantees. 13 categories. They allow you to fill in up to five. And this includes a list of both personal and various government form of guarantees, including small business administration guarantees. If you have a guarantee that is not on the list, again, you check, "Other," and fill it in a free-form text field.

Credit purpose. There are 14 listed. You could identify up to only three here. You may, but are not required to present the list of the categories from the guide to the consumer. You could even ask about categories that are not listed, because if in fact the type of credit purpose is other than what is on the list ... You again check, "Other," and fill in a free-form text field.

Now, the amount applied for. This would be the initial. You capture the initial amount. If it's open-end, it would be the credit limit, in fact, that was requested. How would you decision the application? They follow HMDA in the decisioning category. If it's originated, "Approved, but not accepted ..." In other words, you actually gave credit approval, not a conditional approval. Only ministerial conditions would apply, but they decided not to accept it.

Denied. "Withdrawn by the applicant or incomplete," so they did follow the HMDA categories there. Now, some interesting differences, however. In the HMDA world, you can only report something as incomplete if you send a notice of incompleteness, and then the applicant doesn't respond within the time allotted. Under this rule, whether you send the notice of incompleteness or simply deny for incompleteness, you can report incomplete. So that's an important sanction that folks are going to have to remember.

The action taken date. They did follow HMDA there as to what it is. For instance, with the denial, it's the date of the denial or the date on the notice sent to the applicant of that adverse action. They followed HMDA when it came to this, and again, that is in the commentary and also the Filing Instruction Guide has information. Now, with denied, as with HMDA, you have to show the principle denial reasons. Here, they give a list of 10 and you report up to four of those denial reasons. Also, HMDA does limit how many reasons you report, and I believe it's also four.

Now, if originated or approved but not accepted, again, that latter is you approved ministerial conditions and they decide not to take you up on the offer. It's the amount that was actually approved or the amount originated. Also, pricing information with these loans. Now, what would that be? Let's take a look at the pricing information that will be required. First of all, the interest rate. Fixed rate, simple, adjustable. They want a little more information on it.

They go a little beyond HMDA here. They want the margin. The value, in fact. The initial rate period in months, if applicable. The index name. Now, key here. If the initial period is up to 12 months, so it's a short initial period, they really want to focus on what rate applies after that initial period. They understand that initial period might have a low introductory rate that doesn't really reflect the actual rate for the transaction. And so, they're looking more at the actual rate for the transaction. That's how they decided to get at that.

Now, as to the index, they give nine specific choices including internal. So if you use an internal index, there is a specific category for that. They do not include the secured overnight financing rate as an index. If you use an index that's not internal

and is not on the list, as you might expect, what you do is you check, "Other," and you indicate what that index is. That's how they are going to collect that. Now, total origination charges. This would be the charges you impose. And as to broker fees, they are included, and how the third-party charges. They are included and they follow TILA finance charge reasoning here.

If the creditor requires the use of the third-party, then those third-party charges are included as origination charges. Or if the creditor retains any part of the third-party charge, then they're included to the extent retained. They followed that in broker fees. There is a special rule under TILA that you include broker fees in the finance charge. They decided to follow that here. Now, although you include broker fees in the origination charges ... Separately, you break them out.

This way, the bureau will know what the total charges are and what were the charges received by the broker. If during the initial year, there are non-interest charges that would be imposed, they want that disclosed. If you know they will be imposed, but you don't know how much? You don't guess. You don't provide an estimate. They're just not reported. If there could be a range ... You don't know exactly, but you know the range. You report the highest of that range.

Here, as John mentioned before, merchant cash advances are covered. What they want is the additional amount, which is the difference between the amount advanced and the amount that they must ultimately pay. Pre-payment penalties. Interesting. Differ a little from the HMDA approach, which does require disclosure of this. But here, you have to disclose whether a prepayment penalty could have been imposed under your institution's guidelines for the particular product. Even if it wasn't imposed, if you could have done it, you would disclose that you could have imposed it.

And then, you actually disclose, "Is there, in fact, a repayment penalty associated with the actual credit product?" A little different there. Again, some distinction that's going to make some operational choices. What we're going to next move on to is some data related more to the business itself. Where are the proceeds going to be used? The bureau decided to come up with a waterfall approach to that. The first choice in the waterfall is ... Where would the proceeds go to, or if proved not accepted, would've been principally applied?

Not necessarily where their headquarters are, if they're going to apply those proceeds somewhere else. If you don't have that, the next step in the waterfall is you go to headquarters. The main office or headquarters of the applicant, if you don't know. If you don't know the first two, then the default is any other address or location associated with the applicant. And it'd probably be good to have an internal procedure to develop your own waterfall or which order you use for these other addresses.

The gross annual revenue for the preceding fiscal year. The bureau indicates this is really asking, "Are you a small business?" Because that's driven by the gross revenue. Now, there is in the commentary a sample data collection statement you could make to elect this information. That statement indicates that the gross revenue is the money the business received before subtracting for taxes and other expenses. So it's a pretty basic definition.

They also want to know what type of business is this. They ask for the six digit North American Industry Classification System code. If you use the codes that were in effect as of January of the year which the application will be reported, that is appropriate. Number of workers, which the rule refers to, "Non-owners." We'll note there's a discrepancy. The Filing Institutions Guide has a range of number of workers. I believe there are nine ranges starting from none, you have no workers, up to 500 or more.

Obviously, that's a lot of workers for a small business. So I think it's probably going to be in one of the lower categories. Now, interesting. The rule text refers to non-owners. The commentary and the financial institution guides refers to principal owners. I think that's what the bureau meant. A lot of small businesses will give half or percent ownership to someone who's really a worker. I think they're intending to capture that person as a worker. Whereas, a principal owner is 25% or more, that they're getting at.

Then, time in business. They want to see. Are we dealing with a startup or a relatively new company? Or a seasoned small business? Obviously, that's often very important in the credit approval process. Because a lot of small businesses fail early on, so they want to do that. Interesting way, the rule here in terms of collecting that information.

If as part of your credit process, you will actually collect the years in business, you report that. If you don't, but you determine that they have either been in business for less than two years or for two or more years, you report that. If you don't collect the information and you haven't made that determination, then you must actually be ask the question, "Have you been in business for less than two years? Or two or more years?" That's going to be one of the key elements. Particularly, with evaluating denial decisions.

Now, here's where we're getting to the focus. Because what they really wanted to do, what 1071 really wanted particularly, was to identify if minority-owned or women owned businesses were facing discrimination or challenges in getting credit. So that is information you will collect. Differing from the proposed rule, although the bureau did request comment on it, is not only minority or woman-owned, but LGBTQI+ as well. Those are the three different categories that you have to collect information on.

Here's the definition. This definition. We're going to look at the sample data collection form to show how you collect this information. That form does have this definition in it, so the applicant can see the definition. If one or more individuals in any of these categories owns or controls ... And that's, "If owns or controls," not both. Owns or controls more than 50% of the business, plus more than 50% of the profits-losses approved to one or more of such individuals.

Now, with an in-person application, you and the applicant decides, "I'm not providing it. I don't want to provide it." Unlike HMDA, you do not record based on visual observation or surname. In fact, the proposed rule didn't provide for that. We'll see a little difference now when we get to ethnicity, race, or sex of the principal owners, where the bureau flipped its position on that. Now, when you request the status. Before requesting it ... This is why the data collection form has this information right up the top.

You have to tell them that you cannot discriminate on the basis of a minority, woman, LGBTQI+ status, or whether they choose to provide the information. You have to make clear there's no discrimination based on that. Key here. And we'll see when we get to a firewall requirement. You must keep this data collection form where you're collecting this information, and also the race, ethnicity, and sex of the principal owners, separate from the rest of the application data. We'll see why that's the case when we get to the firewall requirement.

Now, data points related to the ethnicity, race, and sex of the applicants or principal owners. They follow pretty close to HMDA here. Though there are some differences. What's a principal owner? Someone who owns 25% or more of the equity interests in the business. Again, with an in-person application, if they do not want to provide the information or simply don't provide the information, you do not collect or report based on visual observation or surname.

Here, this differs. In the proposed rule, the bureau proposed collecting this information based on visual observation or surname. In the final rule, they decided not to do that. Again, before requesting the information, you have to advise that you cannot discriminate based on this information or whether they elect to provide it. Now, there are little differences and we'll see when we get to the form. While they follow HMDA, unlike HMDA for Black or African-American, there are subcategories.

That's not the case for HMDA. We're expecting, at some point, HMDA will probably be modified. The rule to cover that. Sex, it's a free-form text field. HMDA, it's male or female. Or the applicant may check both. This is just a free-form text field. Again, this collection must be separate from the data, other than the minority women or LGBTQI+ data. Finally, we'll also put the number of principal owners based on the definition. Obviously, there could be no more than four of that.

Let's take a look at the sample data collection form. Those who are familiar with HMDA, this will look familiar. Some of the introductory statements. Although, this one's more related to small business. The second page looks a lot like the HMDA form. The federal law is requiring it indicates discrimination ... You cannot use this information to discriminate. Notice the first line of the second paragraph indicating that one or more employees involved in making a determination may have access to this information. If you establish a firewall, not granting those people access to that information, you can delete that sentence.

However, you may disclose this on an application by application basis, whether or not you'll follow the firewall. Or you can give this sentence to all applicants even if there is a firewall. So that's an operational decision for you when you get to that. This does, as I said, indicate what the definition of a minority, woman, or LGBTQI+ is. As to these categories, the applicant can identify two or even all three. The applicant makes the choice. Whatever they indicate, that is what you report.

Again, the number of principal owners in there is the definition for principal owners. They indicate what minority means. Again, it's the HMDA categories of Hispanic, Latino, American-Indian or Alaska Native, Asian, Black, African-American, Native Hawaiian or other Pacific Islander. Now this, like the HMDA data collection page, it has the different subcategories for Hispanic, Latino, Asian, and Native Hawaiian.

As I indicated, the differences are, however, free-form field only for sex or gender. For Black or African-American, there are subfields. This is what it looks like and the applicant fills in. Again, you do not do this. This is only whatever the applicant

reports. Now, what if they fill in some of this information and then also check, "I wish not to provide." You report what they check. And that's the same for minority, women-owned, LGBTQI+ or ethnicity or race or sex. If they provide some of the information and also check the box, "I do not wish to provide," you report whatever they provide. They followed the HMDA rule when it comes to that.

With that, now let's move on to basic rules. You must have procedures. We'll get into this with Dave's discussion a little more on operational issues ... Both written and actual, reasonably designed to collect the data. They really, really, really, fill in as many really's as you want, want you get this data. I think that's going to be one of the important things out of front. I won't read everything here, but you have to have procedures reasonably designed to collect the data, which at a minimum, must include the following items.

Now they do indicate, all else being equal, asking earlier in the process is probably better and more likely to get the data than asking later in the process. They also say, you may, but are not required to ask more than once. If you don't get it, I think asking more than once would probably be a good idea. Again, you also have to then have procedures to see, "Hey. Am I perhaps not collecting as much as I should? Could some people be discouraging this?" You need to monitor for that.

Finally, the firewall. Any office or employee who will make any determination ... And there is some guidance on that regarding the application. Setting the interest right. Thumbs up, thumbs down on approval. All the other terms you might be offering. They are not allowed to have access to the minority, women, or LGBTQI+-owned business status, info, or the race, sex, ethnicity of the principal owners.

However, if you decide that it's not feasible to exclude access to that data to any individual ... They are permitted to have that access, but you must give that notice that was in the sample collection form and use that to notify the applicant. "Hey. Someone making a decision on your application has access to this information." This looks to be a big thing between a big institution, smaller institution thing.

A smaller institution is often ... The person taking the application is going to be very much involved in the decision, so the one collecting the information will also be involved. So this is one that's interesting. Now, as I said, you can decide on a case by case basis whether to give that notice. Or you could just give it to every applicant, even if you put a firewall in-place in someplace. Again, it's in the sample form.

Countervailing factor is separate. You must have information on whether you are making covered small business loans. And then, in the number, that makes you a reporting entity. You do have to have that information readily available. It can't be something you have to go to a paper file to look at or retrieve from storage. It probably has to be electronic. You've got to remember, "I also have that data requirement as well." And that seems to add some operational issues.

Alan Kaplinsky:

My thanks to Rich and John. Let me remind all of our listeners to tune in and download next week's podcast show, because that will be part two. We will have a very special guest on that program next week, David Skanderson, vice president of Charles River Associates. To make sure that you don't miss our future episodes, please subscribe to our show on your favorite podcast platform, be it Apple Podcasts, Google, Spotify, or wherever you access your podcast shows.

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