Consumer Finance Monitor (Season 6, Episode 23): The Consumer Financial Protection Bureau's Final Section 1071 Rule on Small Business Data Collection: What You Need to Know, Part II

Speakers: Alan Kaplinsky, Michael Gordon, and David Skanderson

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 council of the Consumer Financial Services Group at Ballard Spahr. And 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'd like our podcast show today, please let us know about it. Leave us a review on Apple Podcast, Google, Spotify, or wherever you access your podcast shows. Also, please let us know if you have ideas or other topics that we should consider covering, or speakers that we should consider as guests on our show. So today's podcast show is a repurposing of a webinar about the CFBPs final section 1071 rule on small business data collection, what you need to know. In last week's episode, we covered the definitions of financial institutions, small business covered application, and some other definitions. And that was done very artfully by my colleague, John Cohan. And then Rich Adriano covered the data points that you need to collect and restrictions on employee and officer access to data. If you missed that podcast show, please, it's still available and it certainly compliments the show today.

And the topics we're going to cover today are going to be compliance dates and the grace period policy statement, which will deal with enforcement of course. And then a CFPB supervision and enforcement. And that's going to be done by my colleague, Mike Gordon. Mike was formally a senior officer at the CFPB for several years before going into private practice. And then we will go to operational issues and implications for fair lending risk management. And that's where our special guest, David Skanderson, who is a vice president of Charles River Associates, will play a very important role. Let me introduce you today. Dave specializes in the quantitative analysis of financial institution regulatory and litigation matters. And advises financial institutions on their fair lending compliance management programs. He's got more than 20 years of experience providing practical solutions to regulatory compliance risk management, risk model governance, litigation and public policy issues. Dave has focused especially on issues related to consumer credit, underwriting, pricing, marketing and servicing, with specialization in the fair lending non-discrimination area. So with that, let me now turn the program over to Mike Gordon.

Michael Gordon:

Well, this is a lot of information coming at you fast and that's the nature of the beast here. This is a major new requirement for entities. It's going to take several years to put into place. And in recognition of that fact, the bureau has announced a tiered approach, a sequential approach to compliance dates. But depending on the volume of your covered loans here. So the way this works is that the benchmark for when you need to start complying is going to be the number of loans for 2022 and 2023 that could have been covered here. So it requires companies to come up with a way to figure out what transactions they're currently doing that could be covered by this rule. And so there's going to be some judgment calls to be made there and the bureau acknowledges that that would be the case.

And it does allow explicitly for you to use any kind of reasonable method to estimate this if you don't have the data that you would need readily available to determine, for example, how many of your credit transactions that would've been covered here went to the appropriately sized or covered entities. But putting those definitional issues aside about how you're going to come up with your numbers, the thresholds here on the slide tell you when the obligations kick in. So for those that have the largest volume, they have the earliest compliance obligations. They have to start collecting this data as of October 1st of 2024. And then report in June of 2025. They're reporting only those last three months of 2024 in that first round of reporting.

So the first data the bureau's going to get under this rule would be three months of data from certain entities that fit tier one, and they'll get that data June of 2025. If you have less than 2,500 covered loans in both those years, but at least 500, then you collect as of April 1st of '25 and report June of '26. And then the lowest threshold here with the longest time to comply are entities that have at least a hundred and then less than 500 covered loans. And those have to collect as of the beginning of 2026, and then they're going to report in June of 2027.

So I wanted to also flag there are some other provisions of the law that aren't strictly just the data collection and reporting, most notably the firewall restrictions that Rich alluded to. And for those kinds of other provisions, the compliance date, it kicks in when you have to start collecting data. So it's the earlier of these deadlines when you have to start collecting. It just makes sense that at that point you need to be complying with the other operational things like the firewall restriction. Now, the bureau does announce that there's going to be a grace period. And in past rule makings, the bureau has adopted grace periods and sometimes they do that after the fact after a rules announced here, knowing this would be an issue. They've incorporated their approach to grace period in this final rule, and it's essentially a 12-month grace period.

And there are lots of reasons why a grace period makes sense with this kind of enterprise. I mean, we're talking about significant systems changes, some cases new software training of your personnel. It involves multiple parts of the organization, loan operations, the IT folks. It can be a quite complicated exercise once it's all put together. And given the complexity of that enterprise, but also the large amount of data, and data points, and sub data points, some level of error and implementation hiccup is sort of foreseeable here. And the bureau takes account of that with this 12-month grace period. It's not a complete grace period, which is why I put it in quotes here. But they do make some expressions of what they think the grace period means to them in this context.

And it means first and foremost they say, "We're going to examine for compliance in the early period. But these are really diagnostic exams, not exams that could lead to a punishment. We're trying to learn how it's being implemented, improve it, educate ourselves and industry on how to do this," which is all well and good if in fact that's the approach they take. And they say that they're anticipating there could be some data errors. If you have data errors and they're not material, there won't be a need to resubmit if you discover that there were some small amount of error in the data that you provided. They address upfront the issue of resubmission and sort of lay out a materiality standard without saying much more about that.

But the real kicker here is if they think you have shown a good faith effort to comply with this rule, they're not going to be seeking penalties. Not become an enforcement matter or even be penalized in the supervisory context, enduring this grace period. And there's a big however though, there's a big however built into that. And in this case, the however is what they've already flagged for folks as what will not qualify as good faith. They provide one example and they went so far as to issue in tandem with the final rule, a separate policy guidance addressing enforcement and supervisory practices here, to talk about this big exception. And this big exception is discouragement. And it's critical to focus on this because this is going to be the early focus of the bureau from an enforcement and supervisory perspective in terms of penalizing and punishing companies who in their months have not complied adequately.

The actual fair lending compliance work and fair lending enforcement is going to trail by several years here. I mean, if we look at the schedule from the prior slides, it's a few years before they have enough data to really, even if they wanted to, start bringing conceivably enforcement matters based on disparities in data between companies or other theories that they may come up with, and how they use the data in the enforcement context. But once the reporting begins and the bureau begins analyzing the submissions, they're reserving a right to come after companies early on even during the grace period, if they have a feeling that the companies have not adequately prevented discouragement in the provision of this data. So they're concerned that companies are going to either intentionally or unintentionally make it such that many applicants don't provide the requested information. Because as Rich explained on many of these dimensions, the applicant can just decline to provide the information and the bureau very much wants the data.

And so they've kind of sent a warning shot that they are going to be scrutinizing what you're doing to make sure that your compliance rates or the through rates of the data be actually being supplied are not indicative of a problem. So they talk explicitly about ensuring that the data requests are prominent to applicants and that it's easy to respond to. They talk about making sure that they're provided the right point of time early enough before you actually get the notification of application decision. They want to make sure the request is made. And they expect companies to be monitoring from the get-go both holistically and across various internal dimensions, what the response rates look like. And to make sure that if they see a low response rate, they follow up and try to remedy it.

So for example, what would this mean for a company? What if one of your loan officers has a really low response rate on this data compared to others, or a particular division, or a product line, or a location? The bureau's basically saying, "We expect you to be on top of this. And if you see any signs of discouragement or any obstruction, anything you infer that there's some obstruction or discouragement in the provision of this data, we want you to correct that quickly and make sure your folks are trained and corrected so that this data flows in the way the bureau expects it to." So because this is conduct that is not going to be covered by the grace over the grace period, it's something institutions need to prepare for early on and be ready from day one to be able to have in place like the monitoring that's going to allow you to catch them and remediate any problems. Or at least be aware of variations in your data that's being supplied because the bureau has made it clear they're going to be asking those questions.

Finally, in terms of ongoing oversight, there are a few issues I want to talk about. First, like HMDA data, this data's going to be made public. And so we don't know all the implications of that. And we've learned some lessons from how HMDA data is used and has been used for decades. But it remains to be seen what the effect of that publication will be, for example, on other regulators in states where the data looks significantly different than other areas. Other state regulators going to feel like this data forces them to have some kind of response. Other federal regulators who will have access to the data, but also it'll be made public.

And of course consumer groups and other advocates are going to have access to these databases, and will certainly want to learn from them and make the points that are important to their advocacy based on what they see in the data. So that's going to be important and I think hard to predict in a sense because there's so many different marketplaces and product types involved here as opposed to the HMDA data that I think it creates a whole bunch of questions that we haven't answered yet about, how can markets be compared to one another? Or should they be? And does what's the role of geography? And is it different for certain types of covered entities here, say women owned versus minority owned businesses? I mean, it raises a whole bunch of questions that regulators and others haven't really had to answer before because it's a new data set.

And on that point, I wanted to, if I could, jump ahead and bring in our guest, Dave, and ask him for his thoughts on this. Because I think it's a fascinating question how the bureau's going to be using this data. Because we know they're going to be incentivized to use the data to bring enforcement matters. The bureau is and has been for much of its history, an enforcement first the kind of agency and certainly true now. But explicitly under the statute, that's part of the purpose for collecting the data. But it's not clear or at least it's not clear that HMDA provides a perfect model for how would one would think about building enforcement matters based on this kind of data.

Like I said, multiple different types of industries which may have very different demographics across all kinds of dimensions. And yet the bureau's going to be trying to, I think, going to be in a hurry when they get this data to do something with it. And so as someone who has to deal with the tough data questions that are going to arise from a data site like this, I would love to get your reaction, David, to that kind of challenge, like the fact that this is a more nuanced and complicated dataset than regulators have had in the mortgage space. What does that mean for how the data can be fairly analyzed in the context of regulatory supervision?

Dave Skanderson:

Yeah, a really good question. I think the key point I would make right now is that there's a lot of unknown there. So I would expect that firstly the bureau and other regulators are going to be doing a lot of exploring and learning based on this data. Both they, and we, and financial institutions out there are going to need to figure out how best to slice and dice the data. As you say, Mike, there are a lot of different product lines, and a lot of different credit purposes as Rich outlined, and a lot of different ways that you can look at those.

I mean, it's possible that based on perceptions or understanding about differences among different types of small business credit, there will be a thoughtful approach to analyzing each different credit line, each different type of credit separately. But it's also possible that there may be some aggregation. So if we're interested in broadly access to credit by women owned and minority owned small businesses, maybe there are some areas of analysis where it'll make sense from the bureau's perspective to group all the stuff together and somehow try to assess the extent of overall credit to women and minority owned small businesses.

Michael Gordon:

And then if you do that, what's the denominator? What do you have to work with as a barometer, what it should be? I can understand that that would be a motivation of the bureau. But aren't we missing some key data to make that kind of judgment?

Dave Skanderson:

Sure. We have to think about two different kinds of analysis that might be done here. So one is from a fair lending perspective, just looking at disparities within a given lender's dataset. That doesn't necessarily need a benchmark or denominator. You're looking at, as I'll discuss, disparities in rates of denial or in pricing for particular products. But if we're asking questions about the overall accessed credit. And whether women owned businesses or minority owned small businesses have difficulties in access to credit, one of the things you want to know is what is the overall population or what does the market look like? Are there businesses out there that are underserved?

And we only get a glimpse of that by looking at who actually applied for credit and was denied. But we don't have a way of assessing if particular group got so much credit or didn't get so much credit, is that good or bad? We can compare across groups, women owned businesses versus businesses not owned by women and see what's the total amount of credit being granted there. But we can't answer the question, is that enough credit? How do we relate that to the overall credit needs of that segment of the business? Now, there may be other data sets such as from the small business administration or from the Census Bureau, the business statistics data that's collected that we could use as a benchmark. So that's going to take some research to figure out how we gauge that question of access to credit.

Michael Gordon:

And I just think it's important for those of us who follow the bureau to acknowledge that those kinds of questions involve value judgments sometimes. And this proposal has a lot of objective data analysis and collection, and they can talk in terms of objectivity. But knowing how the bureau operates, sometimes the value judgments of what they believe to be true or want to be true about credit markets, seeps into how they enforce the law. And they will use data sometimes to support those value judgments or to try to support a position that they think furthers those value judgments. And I'm concerned about that. And the proof will be in the pudding on this, but I think it raises a lot of interesting questions. The other thing I wanted to flag about this is for providers out there who are listening to this, whose consumer base has relatively low, is lower on the credit score scale, or has a higher proportion than the general population of minority borrowers or that kind of thing, you're already used to being aware of this kind of risk.

But of course, what the bureau cares about is not just access to credit but access to fair credit. So even if you are a provider whose data is going to show a lot of lending to protected classes under a [inaudible 00:24:55] to like... The credit terms are going to be scrutinized and the bureau just from seeing their past approach to enforcement, will want to protect what it views as vulnerable classes of consumers that don't think are getting a square deal and that are being targeted in some way. And so there's at least two sides to this coin and maybe more for in terms of the risks that this data can present. And it's going to be fascinating to see what the bureau does with it once it does have the data in hand.

But I would just say for the short term, there's not only a lot of work to do to prepare for the data collection engine that you need to build, but also the monitoring that's got to happen immediately in light of the discouragement that the bureau is so concerned about. And we're already starting to talk to clients about both those dimensions. But with that, I'll pass it over to you, David, I think you're up next.

Dave Skanderson:

So I'm going to talk a bit about operational issues and then talk about fair lending. Really kind of roofing off some of the points that Rich made and that Mike made. On the implementation, as I think Rich pointed out, there's call it a buzz phrase. And I think everybody who's involved in this topic and who's going to be responsible for reporting, needs to basically memorize the phrase, reasonably design procedures. So throughout the rule and the bureau's discussion of the rule, the phrase, reasonably design procedures, appears everywhere. There are over 300 references to that phrase throughout the rule and the discussion. And so I think the bureau's really serious about that concept of reasonably designed procedures. And those are procedures for both the overall process of collecting data and for the collection of data about each individual data point. And this is a departure from the HMDA rules from a rulemaking perspective, in that the bureau's being very prescriptive and being very emphatic, I think, about the process for collecting data. And this is going to have important operational impacts for the lenders out there.

First of all, I think one of the key themes that is woven throughout the rule is this concept about concern regarding discouragement. So a financial institution must not discourage any applicant from responding to requests for applicant provided data. And that concern about discouragement appears throughout the rule. Secondly, a financial institution has to structure the request for information in a way that would not discourage response or make it difficult to respond. In fact, at one point in the rule, they actually seem to prod lenders to be proactive in trying to collect this information, just making sure that there are active efforts to collect it where reasonably possible. And then third, as I mentioned, reasonably designed procedures to collect each and every data point. So this paints a picture of an examination strategy in the initial exams as Mike mentioned during the grace period. I think we can expect the bureau to be looking not just at auditing the data, but looking at the overall process for collecting data, what the documented procedures are, what the information technology controls are around the data collection. And evaluating whether the procedures are reasonably designed.

And they tell us in the rule thematically, what they consider to be reasonably designed are the parameters of a reasonably designed procedure. Number one, the timing of the initial data collection attempt. So they want the data collection, particularly the applicant provided information about race, ethnicity, and ownership as early in the application process as reasonably possible. So you can't go through the whole application process and decide after you've made a credit decision to ask for this information. It has to be a timing that is reasonably designed to encourage response. Second, there's a requirement that the request be prominently displayed. And Rich talked about the sample data collection forms. So it has to be prominently displayed or presented to the applicant to encourage response again. Third, there can't be anything about the request that has the effect of discouraging an applicant from responding. So there we have discouragement again.

And then fourth, it has to be easy for the applicant to provide a response. They shouldn't have to jump through hoops. It should be something that they can easily provide. So I'll just mention a few operational implications of this. I'm just going to go through this really quickly. Number one, I think a lot of lenders are going to have to think about redesigning their application process and their application forms to collect the data in a compliant manner. You've got to really think about how the application process works, and what forms you use, and whether they're going to satisfy those four requirements of what constitutes a reasonably designed procedure. And along those lines, I think this is going to encourage a lot of push for automation. System controls on data entry as much point and click data entry as possible. You don't want to have a lot of manual data entry where you can avoid it because that's just increase in the potential for error. So the rule, I think, favors transition to electronic forms of applications where you currently have manual processes.

So tech-savvy lenders, online lenders who already have electronic automatic application and underwriting processes are going to have a bit of an advantage here. For other folks, it's going to be a bigger lift to re-engineer their systems and processes. Training's going to be another big thing there. There's going to need to be training about the data collection process along the entire food chain of data collection from application all the way through to submission of the data to the CFPB. And particularly for the front end folks who deal with applicants, loan officers, relationship managers, account executives, they're going to have to be schooled on how to collect the data in a compliant way. Data integrity is going to be a big challenge.

One of the things that we learned from HMDA over many years is that getting accurate data is particularly difficult for loans that an institution does not make. So non originated applications. You're going to need to care about non originated applications and making sure the data's correct. And that's particularly going to be a challenge when you have changes in the

data over the application process such as with negotiation and renegotiation, deal structuring, changes through the underwriting process. All of that is going to have to be accounted for in operational procedures to get the data right.

Lenders that deal with multiple lines of small business lending that are reportable are then going to have to worry about system integration. In order to submit this data, your small business credit card, equipment financing, you name it, is all going to have to funnel together into one place. All the data from each of those lines is going to have to be accurate and it's going to feed accurately into a centralized repository where you can report it all together to the bureau. That's a big technology challenge. We know that from HMDA. And I think it's pretty obvious on the face that that's going to be a big lift. And then quality control on the data. The bureau is pretty prescriptive in the rule about procedures for monitoring the collection of the data to ensure it's accurate and to allay concerns about potential discouragement. I think Mike mentioned a bit about that.

But they lay out six points in the rule. I'll just refer you to the rule there and not go into it. But they basically expect that lenders are going to have really careful monitoring. And not just audit of the data, but actual data analysis to detect any significant irregularities that might suggest discouragement, or obstruction of an applicant's preferred responses, or just failure to collect the data. Not just in the aggregate, but looking at each division, each location, each loan officer, or other divisional considerations in an organization to make sure that consistently all the data's being reported. And then of course, remedial action if you find issues. So there's a lot to deal with there from the perspective of operational issues to get the data right. Let me turn now to fair lending. So one of the explicit statutory purposes, probably the primary purpose of the section 1071 rule is to enforce fair lending laws.

So the bureau is going to be focused and other regulators are going to be focused on analyzing this data to examine whether there is evidence of potential discrimination in lending. And I think that we can expect the focus, at least initially, to be on three general areas. One, like Mike and I discussed, the question of access to credit. Two, underwriting. Three, pricing. So on access to credit, I really think about a few different themes. One is the concept of redlining, which is a big focus in residential consumer lending. Is there any evidence that a lender is avoiding or failing to lend in areas of high minority concentration? And here, I think, we're going to be looking at not just the distribution of credit between minority areas and non-minority areas. But also the distribution of credit to minority owned businesses versus non-minority owned businesses, to woman owned businesses versus businesses that aren't owned by women.

And also given the data collection credit and the access to credit for LGBTQI+ applicants who actually provide that information. But there's also based on the data collection likely to be some focus on reverse redlining or predatory lending. So whether lenders are targeting minorities, or women owned businesses, or minority areas for credit products that might be viewed by the bureau as having predatory elements like the imposition of prepayment penalties. Rich mentioned how that information's going to be reported, not just whether there is a prepayment penalty on a credit product, but whether one was available. So you could look at, for example, disparities in the imposition of prepayment penalty provisions between say white and minority borrowers, relative to those products that have the potential to have a prepayment penalty imposed. Very different from what we could do with hundred data, for example.

On the underwriting topic, just like in the mortgage lending space, I expect there's going to be focus on differences in denial rates, disparities in credit decisions, in other words. But the data also will allow regulators to look at differences between the amount of credit requested and the amount of credit actually granted for originated loans. So that's another dimension that we don't have in the HMDA space, where you can potentially analyze disparities in the amount of credit granted. So our, for example, women owned businesses more likely to be counter offered to a lower credit line or credit amount than other businesses. And then on pricing, as Rich outlined, there are a number of data elements related to pricing, some of which are applicable to particular types of credit. But there's a lot of information that's going to be reported around pricing that will be a focus to see whether say traditionally disadvantaged groups are on average receiving higher pricing.

But the key thing to keep in mind with all this analysis, particularly the underwriting and the pricing, is that the data for analyzing those things is really going to be limited. We're not going to have any information about the financial or credit characteristics that go into underwriting or pricing decisions. We'll just know what the gross outcomes are, and we can do some slicing and dicing based on products and certain product terms. But we won't know, for example, whether disparities we see in the raw data actually represent a fair lending risk. That's going to come, I think, through the examination process and the kinds of additional data that the bureau ends up requesting or other regulators end up requesting as part of the examination process.

So I think the things that I would suggest lenders keep in mind are thinking forward to all of this data reporting. You really need to get ahead of the reporting and collection of the data in terms of fair lending analysis. So start looking at the transactions that are going to be reportable. And start to do analysis ahead of time to number one, look at data availability, particularly data that will be required to explain disparities that we see in the reported data. So it may or may not be the case that a lender has in their data systems, all the information that drives the credit decision. Ideally, in order to explain what caused disparities that we see in the raw reported data, we're going to need to have available all the data that goes into those decisions so that we could do some statistical analysis and hopefully, demonstrate that to the extent we see disparities. They're driven by objective non-discriminatory factors in a lender's lending policies and guidelines in order to do that.

And then essentially mounted defense when asked about disparities in the data, lenders are going to need to make sure they have all the data to back up those decisions. So I think one of the effects of this rule, both operationally and from a fair lending perspective is that it's going to encourage lenders to really focus not just on the reportable data, but on the data that you need to explain your credit decisions. And just like in the HMDA space, we can expect that over time as the bureau and other regulators examine and analyze this data, they'll start to develop a standard wish list. In the HMDA space, we refer to this as HMDA Plus data. So additional data elements beyond what's required for HMDA reporting that relate to all the determinants of credit and pricing decisions.

We can expect a similar kind of template to be developed here for the purpose of examination. And my general philosophy in thinking about fair lending risk management is really know thy self. You've got to examine yourself for lending disparities and see if they're explainable on a non-discriminatory basis if you want to be prepared to address questions that may come up on examination.

Alan Kaplinsky:

I want to thank very much my colleague, Mike Gordon. I also want to thank our very special guest, Dave Skanderson, from Charles River Associates. To make sure you don't miss our future episodes, subscribe to our show on your favorite podcast platform, be it Apple Podcast, Google, Spotify, or wherever you listen. Don't forget to check out our blog, consumerfinancemonitor.com, for daily insights on the consumer finance industry. And if you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Thank you all for listening and have a good day.