Consumer Finance Monitor (Season 6, Episode 33): An Even Deeper Dive into the CFPB's Final Dodd-Frank Section 1071 Rule on Small Business Data Collection

Speakers: Alan Kaplinsky, John Culhane, Rich Andreano, Lora Kilson, and Kaley Schafer

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 about the topic that we are going to be discussing today, or any other topic in the world of consumer financial services. Don't forget about our blog. In fact, you should subscribe to it. It's called consumerfinancemonitor.com. We've hosted the blog since July 21 of 2011, which was the very day that the CFPB became operational. So with our blog being ongoing now for more than 12 years, there is a ton of industry content there.

We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or get on the mailing list for our webinars, please visit us at ballardspahr.com.

If you like our podcast, please let us know about it. Leave us a review on Apple Podcasts, Google, or wherever you obtain your podcasts. Also, please let us know if you have any ideas for other topics that we should consider covering on our podcast show, or speakers that we should consider as guests on our show.

So this is a repurposed webinar from June 15th that was called An Even Deeper Dive into the CFPB's Rule on Small Business Data Collection. In this webinar, we addressed questions that we received at an earlier webinar that we conducted on April 17th, and that was called the Consumer Financial Protection Bureau's Final Section 1071 Rule on Small Business Data Collection: What you need to Know.

Subsequent to both webinars taking place, litigation has ensued, not surprisingly, because it seems like anything that the CFPB does these days gets challenged. A lawsuit did get filed subsequent to our June 15th deeper dive, where we answered all the questions from the April 17th webinar.

Let me give you a little bit of background about that litigation, because, as things stand now, we're in the bizarre position of only certain banks being subject to a preliminary injunction that was issued by the court in that lawsuit, preventing the CFPB from enforcing the CFPB small business lending rule against certain parties, but not all parties. It's a little bit complicated, so bear with me.

The lawsuit got filed by the American Bankers Association, by the Texas Bankers Association, and by a small community bank in Texas called Rio Grande Bank. Of course the lawsuit was filed in federal court in Texas. Why was it filed there? Because that is where the original lawsuit that got filed challenging the payday lending rule got filed. That then led to the Fifth Circuit opinion in which the Fifth Circuit said that the CFPB's payday lending rule was unconstitutional because of the way the CFPB was being funded, by getting funds directly from the Federal Reserve Board rather than being subject to annual congressional appropriation.

That case now, as I'm sure all of our listeners know, is now pending before the US Supreme Court, with oral arguments scheduled for October 3rd of this year and a decision to be issued sometime between then and June 30 of next year.

So the lawsuit got filed, and the plaintiffs, the two trade associations and the small Texas bank, argued that this new CFPB small business lending data collection rule was invalid. One of the grounds it gave for being it invalid was the Fifth Circuit opinion in CFSA versus the CFPB, which declared that the CFPB's funding mechanism was unconstitutional.

Then after the brief was filed, the plaintiffs filed a motion for preliminary injunction seeking to enjoin the CFPB from enforcing the rule. They sought a nationwide injunction.

A very strange thing happened, something to which I alluded just a few minutes ago. On July 31, the federal district court that was hearing the lawsuit challenging the validity of this rule under 1071 of Dodd-Frank issued an order preliminarily enjoining the CFPB from implementing and enforcing the rule pending the Supreme Court's reversal of the CFSA versus CFPB case, a trial on the merits of this new lawsuit, or until further order of the court.

However, to the great disappointment of many observers, including myself, the court denied the plaintiffs' request for a nationwide injunction and granted the injunctive relief only to the plaintiffs and their members. The plaintiffs are, again, the American Bankers Association, the Texas Bankers Association, and Rio Grande Bank.

And so, the judge said that in order to get this relief, in order not to have to start complying with this new CFPB rule, you had to be a member of the ABA or the TBA. Really bizarre. You might wonder, well, how did that happen? Well, that happened because of an argument that was made by the CFPB. The CFPB opposed the motion for preliminary injunction in general. But then they said to the court, "Even if you don't deny the motion for preliminary injunction, which we want you to do, we're going to make an alternative argument that if you grant the relief requested by the plaintiffs, the relief should be limited only to the plaintiffs and their members."

As the plaintiffs argued in their reply brief, the CFPB's argument failed to address the controlling precedent in the CFSA case, where relief from having it comply with the payday lending rule was granted on a nationwide basis.

So what happened after that order came down and opinion on July 31? There were various other financial institutions who were pretty angry, who couldn't figure out why they weren't given the benefit of the injunctive relief, and that included any bank that didn't belong to the ABA or TBA. It included all credit unions and it included all non-banks.

So what is going on right now is a flurry of other developments with people writing letters, trade associations writing letters to Director Chopra, saying, "You should do the right thing." In fact, I even separately blobbed about it and urged Director Chopra to apply this injunctive relief broadly to include everybody covered by the rule.

Then other parties have begun to seek to intervene in the lawsuit in which the ABA and TBA are involved, a couple trade associations representing banks, many of whom are not members of the ABA and TBA. I would imagine the lawsuits will also be filed soon by a credit union trade association and by a trade association of non-banks. They will seek to intervene.

CFPB has not objected to the intervention of the two trade associations that represent the smaller banks. They haven't objected to that. The court still has to act on the motion to intervene, and then they will have to file their own preliminary injunction motion, and the court will have to decide whether they have standing, and if they do, whether they should be extended the same relief.

I'm sure we're going to go through the same process probably three times, with another lawsuit being filed by one or more credit union trade associations, and then further motions to intervene being filed by trade associations that represent non-banks.

So it is a mess right now, but I think when all the dust settles, what will happen is the judge may be pulling the CFPB along an unwilling manner, because I don't think the CFPB wants to do anything right now to delay any regulations. It thinks it's going to win this case before the Supreme Court. But I think when the dust settles, there will be the equivalent of a nationwide injunction, and this rule will be put on ice at least until the Supreme Court decides the CFSA versus CFPB case. That may not happen it could be as late as June 30 of next year. I happen to think it will happen by late this year or the early part of next year, but who knows?

The pattern that we're seeing develop here, I'm sure, is although not germane to the podcast that we're doing today, we're going to see it repeated again when the CFPB gets around to finalizing any other rules, including the late fee rule which everybody's expecting will be finalized before the end of the year.

Okay. On April 17th, we held a 90-minute webinar, which we took what I would describe as a pretty deep dive into the CFPB's final rule implementing Section 1071 of the Dodd-Frank Act. 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, minority, or LGBTQI+-owned small businesses.

We expected there to be a high level of interest in this rule because it expands the reach of the CFPB's enforcement jurisdiction to many more lenders. However, we never anticipated that this webinar would be a record-breaker for us, and it generated such a high volume of questions, dozens and dozens of questions, that we believed that in addition to responding individually to the people on the last webinar who posed questions to us, we thought that all webinar attendees and those that were unable to attend our first webinar could benefit from many of hearing these questions and, very importantly, hearing our answers to them.

The questions and our responses address a wide range of challenging issues, such as when an institution must start collecting and reporting data, distinguishing between business purpose and consumer purpose transactions, the rule's exclusion of leases and other transactions, the rule's application to indirect auto finance companies, complying with the rule's firewall requirement, the application of the grace period and public disclosure of data.

In this webinar, after I complete my introduction, we will share those questions with you, and my colleagues at Ballard Spahr, whom I will introduce momentarily, will have answers to those questions.

So without further ado, let me introduce my colleagues that are joining me today. First on your screen is Rich Andreano. Rich is the chair of our Mortgage Banking Group at Ballard Spahr. Most importantly, Rich is our leading expert when it comes to the Home Mortgage Disclosure Act or HMDA. So much of this new regulation looks like the regulations that apply to maintaining and disclosing data regarding applications for residential mortgage loans.

Next to Rich is John Culhane. The best way I can describe John, who I've practiced with longer than any other person in the Consumer Financial Services Group, 28 years or so, at Ballard Spahr and then we were at a prior law firm together, he disproves the old adage of jack of all trades, master of none. He is a jack of all trades and a master of all of them, as I'm sure you've heard him on many of our other webinars talking about all kinds of different subjects.

Then next up is Loran Kilson. Loran joined us last year. She is an associate in our Consumer Financial Services Group. Prior to joining us, she was senior regulatory compliance counsel at the National Association of Federally Insured Credit Unions.

Last but certainly not least is Kaley Schafer, who also is an associate in our Consumer Financial Services Group, who joined us last year. Prior to joining us, she served as director of regulatory compliance at the National Association of Federally Insured Credit Unions.

So the final thing I'm going to mention, and it's just I think of academic interest because I don't think it will ever come to fruition, members of the Committee on Financial Services in the House have filed a joint resolution under the Congressional Review Act to disapprove of the regulation promulgated by the CFPB under 1071.

The reason that this will never work is very simple, that even if it does get through the House, which it very well might because of the Republicans having some margin of control in the House, it probably won't make it through the Senate. There is a chance it might, but it probably won't. But even if it does, it's pretty absolutely 99.99% sure that President Biden will veto it. In that case, the Senate would have to garner 60 votes to overcome that veto rather than a simple majority under the Congressional Review Act.

So let's go to the questions. We've organized these questions pretty much the way we organized our original webinar on this subject.

So we're first going to talk about identifying what is a covered transaction. I'm going to call on John to answer that question. So, John, how do we treat a loan that's made for both business and personal purposes?

John Culhane:

Well, the rule here is that we look to determine the primary purpose of the loan at the time of application. That's the controlling factor regardless of whether the borrower is an individual. There are different ways to do that. I can elaborate a little bit more in connection with the next question.

Alan Kaplinsky:

Yeah. How do we determine whether a loan is consumer-designated and excluded under the rule, John?

John Culhane:

So it's the same task. Consumer-designated is an odd term that the CFPB used in the rule and the supplementary information. A transactions consumer, it qualifies as consumer-designated credit if it's offered or extended primarily for personal, family, or household purposes. So an open-end credit account that's used for personal and business purposes isn't business credit if it's designated as primarily for personal, family, or household purposes.

There's a comment in the commentary to Regulation B that says that the creditor can rely on the applicant's statement of purpose for the credit requested. So one obvious recommendation here is that anybody who doesn't have a statement of purpose on their application should consider adding one.

So certainly with regard to an account that's an account with an individual applicant and the business use box is checked, that would appear to be a covered transaction. That might be a little trickier with an account with a business co-applicant even if the box is checked. Although a purpose box is supposed to be determinative, the CFPB might expect an institution to drill down a little more and look to see why the business is actually involved, as that may be evidence of use primarily for business purpose.

Otherwise, in the absence of a box, we basically have to look at the facts, size of transaction, other aspects of the transaction.

Alan Kaplinsky:

John, what's the difference between a renewal and a refinance for purposes of determining whether to report the loan?

John Culhane:

Well, renewals are excluded and don't have to be reported where a refinance does. The CFPB seems to be using the Regulation Z definition of a refinance here. So that's a transaction where the existing obligation is satisfied and replaced by a new obligation undertaken by the same borrower. So if you see those facts, if the existing obligation is effectively torn up and replaced, then you have a refinance that's a new transaction and you have to count that transaction. It's a covered transaction.

Alan Kaplinsky:

Yeah. Okay. Let me now go to Loran, and we're going to talk about the next series of questions and answers pertaining to determining the compliance state. So, Loran, let's start with the first question. If we only start providing commercial loans in 2023 and meet the originations threshold in 2023 and 2024, when must we start collecting data and when must it be reported?

Lora Kilson:

Yes, thanks, Alan. So if you only just begin to originate commercial loans that would be covered by this rule this year, your institution does not fit in one of those first top three tiers for the earlier compliance date, but you would use the later compliance date of 2026. So that means for the calendar year of 2026, that's when you would collect data for your loans that you're originating, and then you would report that data in 2027 on the reporting date.

Alan Kaplinsky:

Yeah. Loran, can we start collecting and analyzing data before our compliance date without reporting it?

Lora Kilson:

So the CFPB allows institutions to start collecting and analyzing its own data voluntarily 12 months before your compliance date. So if your compliance date is ... You're supposed to start collecting that data in 2026, you can volunteer to collect that data and analyze it on your own, just to see that you have your systems up and running. You can do that in 2025. So it's for that 12-month period beforehand, but it's not for right now.

Alan Kaplinsky:

Okay. Is there any requirement to collect data on loans already originated, or are we only collecting data on a going forward basis?

Lora Kilson:

Yes, we've gotten in this question a few times. The data collection is going to be moving forward. So there's no obligation to go back or even collect this data on loans that you are originating this year or loans that you originated last month or anything like that.

You will need to look backward for 2022 and 2023 just to determine how many covered originations you have to determine your compliance date. But you do not need to collect any other data on those loans. You just need to be able to identify how many loans you have originated.

In terms of the actual data collection, that's just going to be moving forward. Once it's time for you to collect the data according to your compliance date, then you collect the data on those loans.

Alan Kaplinsky:

Okay. The final question, Loran, is the grace period in the rule only for the initial 12-month period?

Lora Kilson:

So the grace period is also connected to your compliance date. So it's the 12-month period following the date that your institution is meant to comply with this rule. So for institutions that are supposed to start complying on October 1, 2024, their grace period starts on that date and carries on for 12 months.

Alan Kaplinsky:

Okay. So on this slide, you referred to it just a couple of minutes ago. But without actually reading the slide, just if you could explain it, what the slide portrays.

Lora Kilson:

Yes. So these are the different tiers. The CFPB has called them tier one, tier two, tier three. In order to identify what your compliance date is, you will need to identify how many covered originations your organization made in 2022 and 2023. The number of those originations is going to correlate with this second column here where it says origination threshold.

So if you have made more than 2,500, you're going to be in that top tier. If you're in the middle and you've made more than 500 originations but less than 25, you're in the middle tier. If you've made less than that, you're going to be in tier three. If you have not made any of these loans at all, then you're also going to be in tier three, and your compliance state is going to be later whenever you actually hit the threshold amount of originations.

Alan Kaplinsky:

Okay. Let me call on John again. So we're going to talk now, John, about origination issues. We have put together three questions. The first one is does originate count loans that we purchase within a short time after origination by another lender?

John Culhane:

Well, the answer is it depends on the relationship between the purchaser and the seller, but purchases are generally excluded. However, as we'll discuss, the relationship between the two entities could drive the decision if both are involved in setting the credit terms for the transaction.

Alan Kaplinsky:

Okay. Where multiple financial institutions are involved in a covered credit transaction, such as when we partner with indirect auto lenders who are not the initial creditor, who is required to report?

John Culhane:

Well, the bureau provided fairly specific instructions as to how to deal with the situation. Unfortunately, you basically have to analyze each situation, each relationship separately to determine who has the reporting obligations.

The way the rules work where more than one financial institution may be involved with a covered credit transaction and more than one financial institution has to make a credit decision in order for the transaction to move forward, the institution that has the obligation to report is the last financial institution with the authority to set the material terms of the covered credit transaction, and that's the result regardless of the nature of the two institutions. Once we decide which entity has the obligation to report, then we can look and see if they're actually covered or not. So a motor vehicle dealer may have the obligation to report, but motor vehicle dealers aren't covered.

The trick here is that the institution doesn't have to exercise its authority, it just has to have the authority, the last say in the matter in terms of who can set the material terms for the credit transaction. So it's really important to look at the agreements in these relationships, because we've seen agreements where after the seller submits the terms for approval, the agreement says that the terms can't be changed without permission from the purchasing institution.

If that's the case, that makes it look like the purchasing institution has the last say on the terms, and the purchasing institution in that situation may have the reporting obligation.

Alan Kaplinsky:

So what about, John, a situation with a captive auto finance company? Are they excluded from the data collection and reporting rule?

John Culhane:

There's no per se exclusion for captive auto finance companies. The bureau was asked to create an exclusion for captive finance companies on the theory that they're essentially operating in much the same way that creditors who extend trade credit operate and trade credit is excluded, but the bureau declined to do so. So in terms of captive auto finance companies, you've got to look at the parties in the transaction and determine who has the final say in setting the material terms. That's what's going to determine who's required to report.

Alan Kaplinsky:

Okay. Thank you, John. Going to the next slide, the topic is identifying small businesses. I'm going to turn now to Kaley. So, Kaley, if a business is a startup and had no revenue in the prior year, do we still need to report a loan to that business?

Kaley Schafer:

Thanks, Alan. This is a good question. So the short answer is, yes, you will need to collect and report the information on that startup business loan. There was a lot of comments in the proposed rulemaking phase regarding startup loans, and the final rule actually adds a comment. There's a comment in the final rule now specific to startups, just instructing financial institutions to report the gross annual revenue as zero, and then a reminder to not include any projected income that may be provided by the startup business.

Alan Kaplinsky:

Right. How do we treat sole proprietors, since the information about the business is just information about the individual, the sole proprietor?

Kaley Schafer:

So if we go back to the definition of a business concern, business concern includes a business entity organized for profit. The final rule clarifies that organized for-profit includes sole proprietorship. So a loan on behalf of a sole proprietor would need to be reported. That sole proprietor is likely to be the principal owner. So you're going to have to include that information on the sole proprietor.

Alan Kaplinsky:

Okay. Finally, Kaley, if a limited liability corporation's created solely for the purpose of owning an investment property and it has no revenue, would it be covered under the rule?

Kaley Schafer:

So this question really focuses on the entity itself and not necessarily the type of loan. Obviously the rule covers small business credit. The CFPB had proposed to exclude loans for investment purposes, but did not finalize that exemption. Instead, we're exempting loans that are covered under HMDA, which includes a home improvement loan, a home purchase loan, or refinance. Most investment property loans are going to fit within one of those definitions.

Alan Kaplinsky:

Okay.

Kaley Schafer:

So I guess the crux here is to focus on the type of loan and not necessarily the type of entity.

Alan Kaplinsky:

Okay. Well, thank you, Kaley. We will talk about real estate loan issues. If we're not a HMDA reporter, are our residential mortgage loans still excluded under the 1071 rule?

Kaley Schafer:

So this is a really good question, and, like I just mentioned on the previous slide, the exception now is any covered loan under HMDA. So as long as we have a loan that is not for a home purchase, a home remodel, or a refinance, you will need to report that under the 1071 rule, so long as your financial institution meets the stated thresholds.

The CFPB has a lot of commentary surrounding this and about dual reporting and minimizing the burden for dual reporting, but understood that there might be some gaps in excluding the information that's covered under HMDA. But if we keep that golden rule in mind, that's how we should answer that question.

Alan Kaplinsky:

Okay. If we make a loan that's secured by commercial real estate, a covered transaction, but the borrower makes less than five million in revenue, is this loan covered by the rule?

Kaley Schafer:

So short answer is, yes, it will be covered under the rule. Keeping our golden rule that we just talked about in place, this is not a loan for a home improvement, home purchase, or renewal. It's for commercial real estate, so therefore it's covered. It's less than five million in revenue, so that's going to be included in the 1071 rule.

Alan Kaplinsky:

Okay. Finally, Kaley, is it true that the rule doesn't apply to multifamily loans?

Kaley Schafer:

So, yes, that is true. The final rule excludes any HMDA-covered loan, but it also borrows the definition of a dwelling from HMDA. And so, in order for transactions to be covered under HMDA, they must be secured by a lien on a dwelling, and that includes any multifamily loan.

Originally, the CFPB proposed an exception for multifamily loans that were going to be five units or over. There was a lot of commentary surrounding that, but they decided to scrap that and just stick with those HMDA definitions. So we'll need to look to those definitions to determine our exclusions.

The CFPB did indicate that if you have a loan that's secured by a non-dwelling such as a hospital or a motel, I think those were the examples they used in the rule, those don't fall within the covered loan definition of HMDA. So those wouldn't be exempted and you would have to report those.

Alan Kaplinsky:

Okay. So let's go now to John and we're going to talk about other excluded transactions, John. Let's start with the first question. Are leases covered under the rules, such as equipment financing?

John Culhane:

Well, the general answer for this is, no, leases are excluded. So a company that engages in equipment financing and offers both loans and leases, would focus on its [inaudible], wouldn't need to be concerned about its leases. But as with much of the regulation, there's some nuance here. So we'll talk about that with the next question.

Alan Kaplinsky:

Okay. Yeah. So are all leases treated the same, or do we have to identify so-called true leases under the Uniform Commercial Code definition?

John Culhane:

All leases are not treated the same. So, yes, unfortunately we do have to identify leases that are true leases, that are excluded from leases that are not true leases as they are included. The CFPB looked at this and thought about using the definition of a credit sale under Reg Z, but it felt that most companies' financing business credit wouldn't be as familiar with that definition. So instead they did refer to the Section 1-203 of the UCC.

Obviously it's a factual analysis, but a lease transaction will not be a true lease and excluded if it creates a security interest. That will happen if the lessee's payment obligation continues for the term of the lease isn't subject to termination, and the less he has the option to become the owner of the goods for no additional consideration or phenomenal consideration. So, unfortunately, we do have to drill down on true lease issues here.

Alan Kaplinsky:

Right. Then, finally, John, can you provide operational guidance on filtering out the nonprofit loans that are excluded?

John Culhane:

Sure, Alan. So Kaley mentioned that only for-profits are included, and that exclusion actually comes from the ... Cross-reference to the Small Business Administration definition of a small business concern, which is a business entity organized for profit. So if you want to take advantage of this exclusion and filter out loans to nonprofits, probably the best way to do that is to have a question on your application that asks the applicant to identify whether a for-profit institution or a nonprofit institution.

Otherwise, you're going to have to look at the documents that are provided in connection with the application process, or you may have to drill down on this by looking at the status of the entity under the law where the entity was created.

Alan Kaplinsky:

Yeah. Okay. The topic now is collecting data. I'm going to go to Kaley and Loran, and as I pose the question, one of you, I'm sure, will answer it. So, number one, can one principal owner or representative of the business provide the demographic information for the other principal owners?

Kaley Schafer:

I'll take the first one here, Alan. I guess the first one and the second one are almost the same, but the final rule requires the loan applicant to provide the demographic information for the principal owners. So the applicant-provided data includes those data points such as the number of principal owners, any of the demographic information, whether you have minority-owned business status, women-owned business status, or LGBTQI+ status. So if you are an applicant, you are going to provide this information. It doesn't necessarily require the principal owners to walk in and also provide this data during the application process.

Alan Kaplinsky:

Okay. Should the demographic information be reported separately by each owner?

Kaley Schafer:

And so, I guess these questions are very, very similar. Again, the applicant needs to provide the information for each principal owner. Obviously this information needs to be provided for each owner, but it doesn't necessarily need to be provided by the owner. The emphasis here is on the applicant versus the owner. If that's the same person then sure. There are separate rules and some commentary surrounding when you have co-applicants or affiliate businesses and when to treat those as a single application. But the onus here is on the applicant to provide that information.

Alan Kaplinsky:

Okay. To what degree can funders rely on data collection by brokers?

Lora Kilson:

Yeah, I'll take this, Alan. The CFPB expects funders to go ahead and rely on the information that is collected by a broker or a third party that is helping a consumer fill out an application, or collect that information and get it to the lender. The CFPB has mentioned this a couple of times in the final rule to remind people that even under circumstances in which brokers cannot ask for the type of demographic information that this rule is asking for, if they're asking for it in connection with compliance with this rule and being able to allow the lenders to get the information they need for the reporting for this rule, then they're not in violation of any fair lending laws by collecting that information on behalf of the lender.

Alan Kaplinsky:

Okay. Finally, can we ask all business borrowers the questions and then filter out the over $5 million borrowers for the dataset? For some borrowers, we won't be clear about revenue until after document verification.

Lora Kilson:

Yes. So the bureau also anticipates that for some borrowers, you will not know if they're a small business or not, or you won't know what their revenue is until further along than the application stage. So it is acceptable. If you have a reason to believe that the borrower might be a small borrower, then it's okay to go ahead and collect that information upfront.

Then if you find out that you actually don't need to report it because the transaction is not covered, then you can get rid of that information later. But there has to be a reason that you think that you should be collecting it.

So if it's already obvious to you that the business is a $20 million business, that's less likely ... That's not as reasonable as if they were closer to a mid-size business and you went ahead and collected that information.

Alan Kaplinsky:

Okay. So, Rich, what I'm going to do is first ask you the remaining questions dealing with collecting data, and then I will go back a few slides to securities-backed loan issues and ask you those questions, and we'll be up to date.

So the first question I have for you, Rich, is regarding the requirement of a covered financial institution to keep the collected democratic information separate, how will this look in practice? Will it be a separate page of the application? Does it need to be retained separately as well?

Rich Andreano:

Yes, and I think this is going to be one of the more challenging aspects of the rule. The data collection form, particularly the completed data collection form, whether in paper or electronic format, should be separate from the application. Now the rule does indicate there's some flexibility in how you maintain that. It does say it doesn't specifically have to be a separate electronic file. It even says if it's paper, you could have one large loan file and the application section is different from the data collection form section.

The problem with that is how do you approve people who are supposed to be walled off, didn't peek at it? So I think at practice, having a separate electronic file and having a separate paper file probably would be the only way you could prove to the bureau that people aren't peeking at the information. But the rule does provide for flexibility. I think we're really going to have to see when the bureau starts coming in and examining what it considers appropriate and what it doesn't.

So this is one I think that probably some more interaction with the bureau before we go effective will be helpful, because this one I see operationally is difficult, particularly for smaller institutions.

Alan Kaplinsky:

Okay. Rich, regarding the firewall rule, is there any definition for what "any determination" is supposed to mean?

Rich Andreano:

Yes, it means participating in a decision regarding the evaluation of a covered application from a small business, or the credit worthiness of a small business applicant for a covered transaction. Now the commentary includes both general guidance as to what this means and also specific examples of what is and is not making a determination.

Now I'm not going to go into all the detail because it's pretty detailed. Even with the detail there, I think we're going to need more guidance. A few examples of making a determination. You're an underwriter. You serve on the credit committee that approves or denies applications. You set the terms of a transaction.

Examples of not making a determination: discussing available credit products with a party before they become an applicant, setting general credit policies of the institution, or collecting information that will be assessed by others to make a credit determination.

Alan Kaplinsky:

Okay. Rich, finally, last question dealing with collecting data, how do we prepare commercial loan staff for compliance? What are the implications for staff who aren't accustomed to this level of data collection and reporting?

Rich Andreano:

Yes, this is something that's going to be very new and foreign to commercial lending staff. If you're an institution that happens to be a HMDA reporter, I think you have a bit of an advantage because you have your HMDA staff that can help with policies and procedures.

I think there's going to have to be policies and procedures as to how you collect this information. Then you're going to have to train to those policies and procedures. If you're not a HMDA reporter, then perhaps engaging with a consultant that is familiar with HMDA would be helpful to help develop these policies and procedures and training.

Now, as Loran mentioned earlier, the rule allows you voluntarily to start collecting data 12 months before you have to officially start collecting it. I think they did that to help with training and to see if your policies and procedures are sufficient and are actually getting responses from the applicant. So I would take advantage of that period to aid in the training of your commercial lending staff.

Alan Kaplinsky:

Okay. Well, thank you, Rich. Now we're going to go back to securities-backed loan issues. So, Rich, our bank offers a securities-backed line of credit that has a variable rate based on SOFR, and maybe you could tell us what that stands for in a minute, that resets every Thursday. How do we record the index value based on the final rule? In the proposed version, it was simply the value at approval, but now it's defined as "the index value used to set the rate that is or would be applicable to the covered transaction."

Rich Andreano:

Yes. So first SOFR or SOFR is the secured overnight financing rate. Various versions of SOFR have been designated as the replacements for the famous Libor index, which is going to be phased out the end of this month actually. We're coming to that. Now I'm assuming this loan they have doesn't have introductory period, or briefly no special introductory period rules.

If the introductory rate period is 12 months or less, and after the period, the rate will go up or move from fixed to variable, you ignore that period for purposes reporting the index and interest information and you report on what applies after the introductory period.

If the period is greater than 12 months, the introductory period, and then the rate resets. Then you report the interest and index information based on the introductory period. I read this loan as it starts of as a federal ARM loan, no introductory period, and it just is going to adjust weekly.

Now the bureau knew index move constantly, and whatever's reported is going to be a snapshot of the value on a particular day. The rule provides with an ARM loan or adjustable rate loan, you report the index value used to set the rate that applies to the loan or would apply for approved but not accept it.

I read that to mean whatever index value is used to set the initial rate is the value that's reported. Sure, it's going to adjust a week later probably, but that's what you could do and that allows an apples for apples comparison by using the index value used to set the initial rate for that particular loan.

Alan Kaplinsky:

Okay. Finally, Rich, how do we report securities-backed loans if the approval amount is open-ended subject to available collateral?

Rich Andreano:

Yes, and for those who are less familiar with securities-backed lending, what it usually is is there is a haircut to the portfolio. They won't lend up to 100% of the portfolio. Various factors that can make the loan amount move up and down, or available credit line move up and down, is what's in it? Tech stocks tend to be discounted more heavily because they're more volatile. What are the stock prices as they move? Are securities added or removed from the account? All these things change the value on a regular basis.

The way I read the rule is that basically whatever the initial line amount is established based on the calculation of the collateral, even though we know it's going to change, you focus on the initial line amount and you report that as the amount of approved credit, because that is the initial amount of approved credit coming out of the gate based on your policies.

Alan Kaplinsky:

Okay. Well, that's very clear. I'm now going to move toward the end to really ... We have two more topics to talk about. The first is tracking and subsequent reports. I'm going to call on Loran to answer those questions. Here we are, Loran. First, might the CFPB request an unperforming originator to offer a product type that the originator's more Section 1070 rule-compliant peers are offering?

Lora Kilson:

So it's unclear what the CFPB is going to do once it begins to identify underperforming originators or institutions that are not having great results with collecting this data or with making sure that their small business lending is diversified in whatever way the CFPB wants to see it.

I mean there has been a big push in the last few years to encourage people to use special purpose credit programs and to track their own HMDA data to make sure that they're being proactive in their own efforts to comply with these rules. So we think that there's going to be a lot more of that type of encouragement, but it's not clear how the CFPB is going to identify or treat institutions that it sees as underperforming.

Alan Kaplinsky:

The second question, is the data collected focused exclusively on the application origination phase of a loan, or will the CFPB request data on the performance of the loan?

Lora Kilson:

As of now, there is no indication that the CFPB will request any data regarding the performance of a loan. So right now, the only thing you're really focusing on is the terms of the loan, the information that you have about the business at the time of application, and when you take action on the loan.

Alan Kaplinsky:

Okay. Finally, Loran, is there a certain amount for an increase in credit to be considered a covered transaction?

Lora Kilson:

So there's not. I think this question is getting at what John spoke about earlier when he talked about what is considered to be a refinance in terms of that being a covered transaction that needs to be reported. Sometimes an increase in credit is not a refinance. It's simply an increase. This is not something right now that needs to be reported or needs to be treated any differently. So you're really going to just focus on the information that you have at origination stage.

Alan Kaplinsky:

Okay. Now we're going to really the final set of questions, and I'm going to go back to Rich, who's going to wrap it up for us. Rich, do we still need to collect this data for loans that are already reported on other forms, such as small business, small farm LAR?

Rich Andreano:

Yeah. The only exception the Bureau created for another reporting regime are loans that are reportable under HMDA. They did not create a similar exemption for loans that might be reported for Community Reinvestment Act or other purposes. So will due reporting be required? Unfortunately, yes.

Alan Kaplinsky:

What data will be made public? Will public data include pricing and the interest rate?

Rich Andreano:

The bureau is going to make both aggregated data, which, as what it sounds, it's data from multiple institutions or the industry as a whole available plus disaggregated data, which is loan application-level data. However, it will first assess whether to withhold some of that disaggregated data from public disclosure or to modify it before disclosure.

Now if we use HMDA as a lesson, the bureau went with disclosure over privacy and discloses a lot of data and a lot unmodified. To give you an idea as to pricing, all the HMDA pricing data is not modified and it includes the total loan costs or fees, the origination charges, the discount points and lender credits, interest rate, prepayment penalty term, introductory rate period, and whether there are non-advertising features. So I would bet heavily that they will disclose the pricing information.

Alan Kaplinsky:

Okay. Finally, Rich, how will the CFPB do a comparative analysis without key underwriting criteria such as loan to value and collateral type?

Rich Andreano:

Going back to HMDA, before the data was expanded in 2018, the industry often said there simply wasn't enough information to do an underwriting analysis. Congress and then the bureau greatly increased the data and added a lot of pricing data as well.

Even with that expanded data, and even given that there's relatively uniform pricing and underwriting standards with residential mortgage loans, you often have to open the loan file to really do an underwriting or pricing analysis. Here there's even less data and there's much more variation in underwriting with small business lending.

Long story short, you cannot make conclusive determination based on the 1071 data. Having said that, the bureau and consumer groups will assert, they can make conclusive determinations. So your institutions need to be ready to do your own analysis of your data and be prepared to fight the arrows off when they start getting shot at you.

Alan Kaplinsky:

Okay. All right. Thank you, Rich. The only other thing I want to say is there is so much activity now in the small business lending area that this is the icing on the cake I guess you could say. But there are all kinds of developments at the CFPB, at the FTC, at the state level subjecting small business loans to the type of regulation that consumer lending has been subject to for decades.

As a result of that, our Consumer Financial Services Group, although we're not going to change the name of our group to the Consumer and Business Financial Services Group, we have put together a group of lawyers, all of whom were on the program today, and there are many others that weren't on the program, that are focusing on these kinds of issues. So you should feel free to reach out to us if you have questions about anything in the small business area.

There is one little bullet that the industry dodged. That is a bill that was introduced in New York State amending its deceptive practices law to cover unfair, deceptive, and abusive acts and practices and would cover not only consumer lending, but all commercial lending, not limited to small business commercial lending.

Fortunately, that did not pass by the time that the legislature adjourned Thursday of last week. But it will automatically be introduced in January, and I am told it's going to be a very difficult bill to stop. The odds are very strong it will get through.

So that's New York, and there are several other states that have joined the bandwagon, subjecting small business lending to consumer lending types of regulations.

So I want to thank my colleagues today who did such a terrific job answering all the questions that had been raised at an earlier webinar that we did back in April of this year. So my thanks go out to John Culhane, Rich Andreano, Loran Kilson, and Kaley Schafer.

To make sure that you don't miss any future episodes, subscribe to our podcast show on your favorite podcast platform, Apple Podcasts, Google, Spotify, or whatever other platform you use. Don't forget to check out our blog, consumerfinancemonitor.com, for daily insights on the consumer finance industry.

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 very much for listening, and I wish all of you a superior day.