



FAST BALL: REGULATORY IMPACTS ON SMALL BUSINESS LENDING

Vance Gudmundsen, *VP Government Affairs and Data Privacy, FICO*

Andrew Smith, *Partner, Covington & Burling*

Kathy Kauffman, *VP Small Business Card, Capital One*

HMDA (1975) Amendments (2015)



- **2010:** Dodd-Frank Act instructed the CFPB to revise Regulation C, the regulation implementing HMDA, in order to increase transparency and promote fair lending in the mortgage industry.
- **2015:** CFPB released a final rule that significantly increases even the expanded scope reporting required by Dodd-Frank, to be implemented in phases between 2017 and 2020.
- No significant changes to the types of commercial transactions reported under HMDA, i.e., a covered commercial loan must be for home purchase, home improvement, or refinancing.
- However, the final rule expands coverage to include **new lenders** and **new data points**:
 - nearly doubles the amount of information lenders must collect
 - 25 wide-ranging, new data points in addition to amending existing disclosures.
 - specific information about the features of the loan, the property, and the underwriting process.
 - borrower's characteristics, such as age, credit score, and debt-to-income ratio. Lenders will even be required to explain how they collected data on ethnicity, race, and sex—whether by visual observation or surname.
- **2017:** CFPB announced in December 2017 that it intends to open a rulemaking to reconsider various aspects of the Bureau's 2015 Home Mortgage Disclosure Act Rule (Regulation C), which could involve issues such as the institutional and transactional coverage tests and the rule's discretionary data points.

Impact of 2015 Amendments



Reduction: (estimated to reduce number of institutions require to comply with HMDA by 22%)

- small depository institutions that are located outside a metropolitan statistical area remain excluded from coverage
- a uniform loan volume threshold that exempts institutions that made fewer than 25 closed-end mortgage loans or fewer than 100 open-end lines of credit in each of the two preceding calendar years, which will reduce the number of institutions required to report HMDA data by an estimated 22 percent

Expansion: (estimated up to 450 new nondepository institutions would need to be HMDA reporters)

- a dwelling-secured standard: starting in 2018, lenders must report on all closed-end loans, open-end lines of credit, and reverse mortgages secured by a dwelling regardless of the loan's purpose
- removed exemption for nondepository institutions with < \$10 million dollars in total assets

§ 1071 of the Dodd Frank Act, “Small Business Data Collection” (effective 2011)



Information gathering - inquire whether the business is a women-owned, minority-owned, or small business, without regard to whether such application is received in person, by mail, by telephone, by electronic mail or other form of electronic transmission, or by any other means, and whether or not such application is in response to a solicitation by the financial institution

Information - race, sex, ethnicity of principal owners; census track; gross revenue of the business for last fiscal year; loan type and action taken; *no personally identifiable data to be collected!*

Records – maintain for 3 years, separate from the application and accompanying information. Access to information is restricted: (i) shield employees involved in the underwriting process; or (ii) if underwriters do have access, give notice to the applicant of that fact and that the lender may not discriminate

Right To refuse - An applicant may refuse to provide any information requested

Annual submission to CFPB

History of § 1071 Rulemaking



April 2011 - CFPB letter to financial institutions that they have no obligation until Regs are issued

September 2011 - CFPB issues rule that motor vehicle dealers have no obligation until Regs issued

August 2014 - National Community Reinvestment Coalition urged CFPB to act

June 2015 - Three community groups in American Banker article urged President Obama to intercede

July 2015 - 19 Democratic Senators urged Director Cordray to issue regulations

August 2015 - 84 House members and 19 Democratic Senators urged action

October 2015 - CFPB posted job opening for the position of "Assistant Director of Small Business Lending Markets", which was filled in April 2016.

February 2016 - CFPB released a statement of its "policy priorities over the next two years," which include small business lending as a "near-term priority goal." In the statement, the Bureau said it would take the following steps in the next two years:

- Build a small business lending team to conduct market research that will provide a factual foundation for rulemaking;
- Build the infrastructure to accept and analyze complaints regarding small business lending;
- Conduct examinations to evaluate small business lenders' compliance with fair lending laws.

CFPB Issues Request For Information



In May 2017 the CFPB issued a RFI about the small business financing market. The comment period closed in July 2017. In addition to the RFI, the CFPB released a white paper outlining the “key dimensions of the small business lending landscape”:

- the definition of “small business”; and potential exemptions from the rule
- products offered to women and minority owned small businesses
- business lending data currently used and maintained by financial institutions in connection with credit applications made by small businesses
- potential complexity and cost of small business data collection and reporting
- privacy concerns related to the disclosure purposes of section 1071.

ABA Response to CFPB's RFI (September 14, 2017)



General Comment:

- CFPB should partner with the SBA to study whether the data and reporting regime envisioned by Congress can achieve its intended objectives.
- Small business lending is highly individualized; underwriting and loan pricing depend on many heterogeneous variables that are inherently unsuitable for mass-data fair lending analysis. Fair lending analysis depends on using mass-data to compare similarly situated borrowers. This is possible to a limited degree with consumer credit, where products and factors considered in underwriting are more homogenous. Commercial lending involves great variations and unique attributes of individual small businesses, which make legitimate comparisons excessively difficult, if not impossible.

ABA's Specific Responses to CFPB's RFI



1. HMDA-like reporting is not appropriate for small business lending and will impose costs on small business customers.
 - More expensive than recent changes to HMDA because those changes were on an existing data set and established reporting regime
2. Small business lending promotes economic growth and financial inclusion.
 - The simplistic data collection contemplated by section 1071 is at odds with the consultative, tailored approach to small business lending. It will tend to encourage standardization and simplification of the commercial loan application, processing, and underwriting processes, which will limit the flexibility that is the key characteristic of successful small business lending, particularly small business lending by community banks.
3. The small business definition must be clear and easy to apply.
 - A small business should be defined as an enterprise (including all parent entities, subsidiaries, and affiliates) that, at time of application, reports the prior year's gross annual revenue as \$1 million or less and has requested a loan amount of \$1 million or less.

ABA's Specific Responses to CFPB's RFI (continued)



4. The Bureau should expressly exclude certain loans from the data collection.
 - Reporting should be limited to commercial loans where the primary source of repayment of the loan is revenues from on-going business operations; this excludes loans that are personal; secured by real estate; participation loans; non-business trusts; tax-exempt entities; foreign-owned entities.
5. To minimize the disruption of small business lending and the cost of the data collection, the Bureau should adopt clear and flexible rules governing the collection and reporting of the data.
 - The bank should be able to define what constitutes a completed application, which triggers the duty to collect and report. Preliminary discussions with a customer about possible financing needs should not trigger an application and a 1071 obligation. Similarly, if a customer asks about a particular type of loan, and the bank does not make that type of loan, the bank should not have to report 1071 data.
6. The Bureau should adopt clear, simple definitions of the legislatively-mandated data points.
 - The bank should be allowed to rely exclusively on answers provided by the applicant regarding gross annual revenue in the last fiscal year and the small business' status as women-owned or minority-owned. There should be no requirement for the institution to verify or validate the information provided apart from the institution's standard underwriting processes. There should be no requirement to coach or to urge the applicant to answer, which could jeopardize the customer relationship.

ABA's Specific Responses to CFPB's RFI (continued)



7. The data collection should be limited to the statutory data.
 - [On the other hand, financial institutions may want to have CFPB require MORE data, to enable more accurate comparisons among small business borrowers; although this adds more operational burden on lenders, and it would be harder to keep data anonymous]
8. Limit 1071 data collection requirements to genuinely new credit to the customer.
9. Permit use of a model disclosure when a firewall is not feasible.
 - To assure data cannot be viewed by underwriters during the application process or afterwards, banks will have to establish and maintain a firewall, and store the data in systems or files that the underwriter cannot access. This would be expensive, as many institutions grant underwriting and loan approval authority (under certain loan amounts) to the same staff that is interacting with customers. To comply may necessitate the hiring of "shadow staff" to collect the demographic data.

ABA's Specific Responses to CFPB's RFI (continued)



10. Mitigate customer privacy and confidentiality challenges by exempting certain small data sets and by using county-level aggregations for all other data.

- The Bureau should establish a minimum size for data sets. To maintain public confidence, banks need to be able to assure borrowers that their information will be treated with the utmost confidentiality. Small data sets within a particular geography are highly likely to lead to the public obtaining information that should remain confidential. In many communities, information about the annual revenue or demographic data about the principal owners of a small business will disclose private information about the small business and its financing needs. Indeed, the mere fact that a borrower is applying for a loan is something that a borrower may not want publicly disclosed. Many borrowers may be hesitant to apply for a loan if that personal information may be made available to the public. In addition, publication of 1071 data may also encourage aggressive marketing by online lenders that may be unwelcome by the borrower. In addition, the type of action taken and the amount approved, among other potential data points, may reveal bank proprietary information.

What is Fintech?

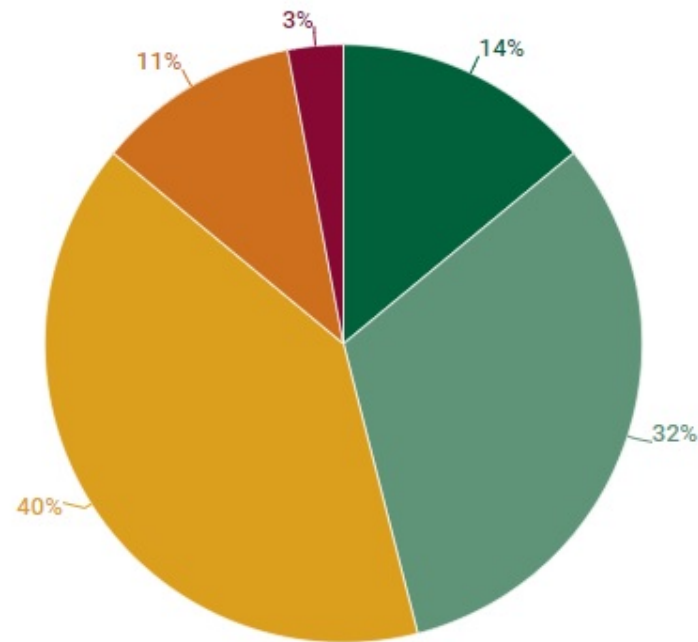


- Lending Club (marketplace lending, sale of payment dependent notes)
- OnDeck (platform made available to others)
- Kabbage (partnering with a bank to offer credit to small businesses)
- Fundation (portfolio lending, secondary market, tech vendor)



Small Biz Owners Finding Capital Access Easier

Nearly half of small business owners believe that access to capital has become easier over the last five years.



Has access to capital become easier or harder over the past five years?

- Much easier
- Somewhat easier
- About the same
- Somewhat harder
- Much harder

Source: Mercatus Center

ABA BANKING
JOURNAL

Fintech Challenges



- 50-state patchwork of licensing and rate/term requirements
 - Payment system access
 - Cost of funding
- Valid When Made
 - Undercuts ability for banks to diversify risk
 - *Madden v. Midland*
- True Lender
 - Undercuts bank partnerships with non-banks
 - *Colorado v. Avant*

Fintech Regulatory Response



- Legislation to address VWM and TL
- OCC Fintech Charter
 - Lending, check cashing, deposit-taking
- OCC/FDIC Third-Party Guidance
- CSBS efforts at uniformity
- CFPB Project Catalyst and No-Action Letters
- Sandboxes and Pilot Programs
 - UK FCA sandbox and US legislation