



## Financial Services Management

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### Small-Business Lending Disclosures

#### Cite

CFPB, Notice of Proposed Rulemaking, Small Business Data Collection under the Equal Credit Opportunity Act

#### Recommended Distribution

Small-Business Finance, Compliance, Risk Management, Policy, Legal, Government Relations

#### Websites

[https://files.consumerfinance.gov/f/documents/cfpb\\_section-1071\\_nprm\\_2021-09.pdf](https://files.consumerfinance.gov/f/documents/cfpb_section-1071_nprm_2021-09.pdf)

### Impact Assessment

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- Small-business/small-farm lending would be more transparent, likely encouraging lender outreach to women and minorities. Market equity and economic development could thus be enhanced.
- However, lender legal/reputational risk would also increase and credit availability might suffer.
- Pricing-data collections as proposed may obscure discriminatory practice and even alter market structure in ways that adversely affect credit availability.
- Both bank and nonbank lenders would be covered, preventing regulatory arbitrage and comparative advantage due to asymmetric compliance costs. However, online lending portals could be exempt from filing certain demographic information if borrowers choose not to provide it voluntarily. Some competitive asymmetry might thus remain.
- Compliance costs would be significant, especially as lenders build requisite data-gathering, management, and reporting systems.

### Overview

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Turning again to a provision in the 2010 Dodd-Frank Act,<sup>1</sup> the Bureau of Consumer Financial Protection has issued a sweeping proposal to implement small-business and small-farm lending disclosure requirements akin to those long required under the Home Mortgage Disclosure Act (HMDA).<sup>2</sup> Although the law

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<sup>1</sup> See **CONSUMER14**, Financial Services Management, July 19, 2010.

<sup>2</sup> See *Client Reports* in the **MORTGAGE** series.

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focuses on lender reports to discern different loan-approval rates based on gender or ethnic/racial groups, the notice of proposed rulemaking (NPR) goes farther also to require extensive detail on loan amounts and pricing on approved loans a borrower chooses not to accept. Data would be required from all but the very smallest bank and nonbank lenders.

## Impact

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Although the Trump Administration's CFPB read the law's requirements narrowly,<sup>3</sup> the Bureau now views the Dodd-Frank Act's provisions requiring these data as a broad mandate to ensure that small-business and small-farm lending is fair and that new insights would promote community development. Based on this reading of the law -- one that some in the industry may challenge -- the agency has developed a new reporting framework mandating up to 23 data-reporting requirements designed to paint a full picture of how lenders provide small-business credit and to whom it goes on what terms and conditions. As with mortgage lending, these data would provide a raft of new insights into a sector essential for economic growth, but small-business reports would go farther in terms of transparency because this sector uses often-opaque algorithmic underwriting more often than residential mortgages (where many underwriting requirements are set by regulated secondary-market agencies and/or guarantors). Online and platform lending and their algorithmic underwriting models may thus exacerbate disparate impact or at the least the difficulty of identifying it. This was a concern as early as 2015, when Treasury highlighted it in a report on online marketplace lending.<sup>4</sup> However, the sector has of course grown dramatically since then.

Small-business lending is also distinct from mortgages due to the role of lenders with other commercial interests that may create conflicts in terms of providing merchants with the least cost, best-term financing. Although mortgage lending takes place in diversified financial companies where cross-selling can create conflicts of interest, these are generally not of the magnitude presented when a tech-platform company is providing goods and services on its own that may directly compete with offerings from third-party merchants also seeking or just incidentally receiving financing from the platform.

However, all these new data and their potential benefits to fair lending will come at significant implementation, monitoring, and reporting cost to virtually all lenders regardless of their underwriting technology and business model. Small lenders will surely be the most adversely affected by these costs due to their limited resources, perhaps persuading some even to exit the sector. To the extent such lenders are community banks, a major source of finance for small business and small farms would be adversely affected. While no community bank on its own is a major small-business lender, these banks in aggregate are among the most vital -- if not the most vital -- source of small-business and small-farm lending.

Although Dodd-Frank gave the CFPB broad authority to mandate these Equal Credit Opportunity Act (ECOA) disclosures, it did not also clearly give the agency authority over small-business or small-farm lending, including with regard to ensuring equal-credit access. The NPR may suggest that the Bureau recognizes

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<sup>3</sup> See **FAIRLEND7**, *Financial Services Management*, July 31, 2020.

<sup>4</sup> See **LENDING7**, *Financial Services Management*, July 30, 2015.

its limited authority, noting that it would refer potential discrimination based on these data to the Department of Justice (DOJ). However, agencies routinely make these referrals when they exercise their own anti-discrimination authority, making it unclear if the Bureau would only refer perceived discrimination or also act on it. The reference to Bureau enforcement actions clearly applies to reporting violations, but is not circumscribed beyond mention also of certain reporting safe harbors. A provision preserving the rule as a whole even if parts of it are successfully challenged may also suggest the agency intends broad enforcement but recognizes that doing so may expose it to litigation challenging its jurisdiction in this high-profile arena.

To facilitate its focus on discrimination, lenders would be required to collect data on gender and minority status, with the Bureau also seeking comment on whether to do so for sexual orientation. These demographic data are to be provided by requests made of applicants but, should an applicant refuse to provide them, the lender would be required to identify race or ethnicity (but not gender) by visual observation in the event of the opportunity to observe the applicant or surname should this not be possible. The extent to which surname assumptions are accurate guides to race and even ethnic status is highly uncertain even as the online and/or platform nature of much small-business credit delivery prevents visual observation. Overall conclusion about small-business lending based on demographic data may be unreliable unless a significant number of borrowers agree to provide these data. Many minority borrowers are likely to be reluctant to do so when it is possible not to do so and seek online channels precisely to avoid the discrimination they fear might result due to self-identification or visual observation. The NPR requires lenders requesting data to provide a notice stating that discrimination based on it will not occur, but the extent to which this would be trusted is uncertain.

As detailed below, the proposal would extend to many forms of business finance for companies with annual gross revenues of less than \$5 million. The definition covers merchant advances and "sales-based financing," terminology that would appear to incorporate the growing number of buy-now/pay-later (BNPL) lenders funding purchases across a wide array of retail transactions. BNPL transactions are essentially consumer-installment credit, but merchants generally pay the lender a fee to receive transaction proceeds immediately before the lender proceeds to dun the consumer. Although the CFPB has yet to set standards for BNPL, it may well do so in the near future as concerns grow and, even should it issue no specific rules, its broad consumer-finance standards against unfair, deceptive, or abusive practice could come into play. Mandating disclosures related to the merchant side of these transactions would not address consumer protection, but would shed light on possible discrimination even as the Bureau decides whether and how to address the consumer end of these loans.

Although pricing is in general a major indicator of potential discrimination, the proposal requires extensive pricing data only for loans a lender has originated and approved but that the consumer does not accept. The Bureau states that pricing related to applications that are withdrawn or incomplete illuminates high costs that would block credit for women and/or minority borrowers. However, this assumes that borrowers are not desperate for credit and thus willing to accept it on

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disadvantageous terms that might be more prevalent for the smaller businesses that are more frequently owned by women and minorities. It also assumes information symmetry -- i.e., that borrowers know that loan terms are disadvantageous and thus reject them.

Loan-amount data would also be required only for originated and approved loans that are then not accepted, again based on the view that the difference between typical loan amounts for funded loans versus those never taken would highlight discriminatory treatment. However, capturing only these data might create a misleading picture of market credit if, for example, borrowers identify alternative sources of financing available from sources such as the significant amounts of credit encouraged by recent federal spending and/or municipal efforts targeted at women and minority firms. Some lenders may also fear offering higher-risk loans to borrowers contemplating a small-business or small-farm start of expansion who, upon realizing these costs, defer or even decide against doing so even though other borrowers are willing to pay such costs from lenders willing to take more risk without greater reward. Finally, discriminatory practices within the far larger body of approved loans would be unreported, complicating assessment of any disparities related to amount or pricing of unaccepted loans or that across the sector more generally.

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## What's Next

The Bureau released this proposal on September 1; comment is due ninety days after *Federal Register* publication, with the Bureau already signaling in the NPR that it is loath to extend this deadline even though industry commenters will surely press for this. The agency is now not only committed to the concept of these reports, but also under an order to expedite them following 2019 litigation.

The rule would be effective ninety days after publication, but compliance would begin approximately eighteen months thereafter. Transition provisions would permit institutions to begin to collect data more quickly. Industry comments will surely push also for slower and/or phased-in implementation.

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## Analysis

As is often the case with CFPB proposals, this one is very detailed, covering more than nine hundred pages with extensive argumentation, background, model forms, and point-by-point rationales for each substantive proposal. This analysis addresses those aspects of the proposal with strategic impact.

As noted, the Bureau has taken the unusual step of making all of the provisions in the final rule severable so that a successful court challenge to one aspect of the rule does not necessarily endanger the rule as a whole.

### A. Coverage

#### 1. Reporting Lenders

"Financial institutions" covered by this proposal are essentially all firms engaging in small-business finance with a credit feature. The rule would thus cover banks

and similar entities, credit unions, online and platform lenders, CDFIs, non-depositories, equipment/vehicle lenders, commercial finance companies, and non-profit lenders. Interestingly, government lenders would also be covered, bringing SBA under the rule with regard to its direct-lending programs.

Only lenders making more than 25 small-business loans a year for the last two years would be covered, a standard likely to cover virtually all community banking organizations.

## **2. Applications**

The proposal defines applications as usual (i.e., oral or in writing), but excludes requests related to an existing loan unless more credit is sought or the application is only a pre-qualification request.

## **3. Loans**

Covered loans are those that meet the existing definition of a "business credit" to a company or farm defined under the CFPB standard to be small including lines of credit, credit cards, merchant cash advances, and mortgages. However, trade credit, public-utility credit, securities credit, factoring, leasing, consumer credit used for business purposes, incidental loans, and certain other activities would be excluded. Covered loans include those for agricultural purposes, thereby extending the scope of the rule to small-farm lending as noted above.

## **4. Small Business**

These would be businesses that otherwise meet statutory and SBA definitions of a small business but that also have less than \$5 million a year in gross revenue, a smaller size threshold than adopted by SBA, leading the Bureau to seek SBA approval of this alternate definition. Agricultural firms are covered within this size threshold.

## **B. Disclosures**

Data that would need to be reported includes, but is not limited to:

- type of credit for which the application is made including any guarantees, loan terms, and other information;
- credit purpose;
- applicant-business details (including number of workers, census tract, type of business);
- principal-owner demographics. Comment is sought on how best to capture sexual orientation and gender identity. As noted, procedures are detailed for how this information is to be captured if the applicant does not provide it;
- unique identifiers;
- application means and from whom the lender received it;
- action taken and date;
- denial reasons; and
- for loans originated and approved but not accepted, loan amount and pricing information (e.g., interest rate, total origination charges, brokerage fees,

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initial annual charges, cost for merchant advances, and prepayment penalties).

### **C. Firewall**

Anyone at the financial institution involved in making small-business credit decisions could not access an applicant's demographic information unless separation of duties at the institution makes this firewall "infeasible" and the applicant or all applicants are notified that demographic information will be shared. Since applicants can refuse to make this known under any circumstance, the applicant could do so if given this warning. A model notice is provided.

### **D. Data Collection**

#### **1. Timing**

Data would be collected every calendar year and reported to the Bureau by June 1 of the following year.

#### **2. Release**

Subject to modifications deemed necessary for privacy protection, data would be released every year by the CFPB. A "balancing test" is proposed to guide the Bureau through decisions about which disclosures best advance social welfare without impinging on personal privacy. A policy statement one year after the first data submissions would detail how this test will work.

### **E. Enforcement**

Failure to comply with this rule could result in administrative sanction and/or civil action and referral to DOJ, but the rule does not make clear if this pertains only to reporting errors or if the Bureau would take enforcement actions not only related to reporting requirements, but also those pertaining to fair lending. However, bona fide reporting errors that are unintentional and occur despite effective internal controls would not be deemed a violation if the number of violations is small as determined by a proposed formula. Four safe harbors for certain errors are also proposed.