CONSUMER FINANCE PODCAST – CFPB'S SECTION 1071 FINAL RULE (PART 3): POTENTIAL PROBLEM AREAS
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Chris Willis:

Welcome to the Consumer Finance Podcast. I'm Chris Willis, the co-leader of Troutman Pepper's Consumer Financial Services Regulatory Group, and I'm really glad you've joined us today for part three of our three-part series on the CFPB's 1071 rule, where we are going to be talking about a grab bag of miscellaneous issues that we think will be either of interest or of difficulty to the small business lending community in terms of implementation. But before we dive into that, don't forget to visit and subscribe to our blog, consumerfinancialserviceslawmonitor.com, where you'll see all the updates we post every day about the happenings in our industry. And check out our other podcasts, we have lots of them, we have the *FCRA Focus*, all about credit reporting, *The Crypto Exchange* about all things crypto, and *Unauthorized Access*, which is our privacy and data security podcast.

And all of those are available on all popular podcast platforms. Speaking of those platforms, if you like this one, let us know, leave us review on your podcast platform of choice and let us know how we're doing. So, as I said today we're rounding out our three-part series on the new 1071 Rule that the CFPB finalized towards the end of March, and today we're going to be rounding it out by talking about a grab bag of issues that as I said, either we think will be of interest to clients or maybe challenging for small business lenders to implement. And I'm really lucky to have three of my colleagues joining me for today's episode. First I have my co-leader of the Consumer Financial Services Regulatory Practice, Mark Furletti, I have our new partner, Joe Reilly, who brings his expertise in HMDA to bear on the very similar provisions of the 1071 rule, and I have our colleague, Christine Emello, who works with us on a number of fair lending matters and so is highly familiar with the concepts that underlie the 1071 rule. Mark, Joe, Christine, thanks for being on the podcast today.

Mark Furletti:

Thanks, Chris, for the introduction. Happy to be here today.

Joe Reilly:

Yes, thanks Chris. Thanks for having me today.

Christine Emello:

Thanks Chris. Looking forward to discussing this rule with all of you.

Chris Willis:

Okay. Well, there's a lot to discuss, so let's just jump right into it, and I'd like to start with a few issues that sort of relate to the coverage of the rule, what's in and what's out? And one of the things that I wanted to bring to our listener's attention is that there's a nuance in the rule that is really important to understand, but that may not be immediately evident if you just sort of breeze over the rule about how many transactions you have to have in order to be required to report

under 1071. The 1071 rule basically says if you're covered, if you are a 1071 reporter, you have to report all applications for a covered small business product if the applicant is a small business. So, that would include an application that's declined, an application that's approved and not accepted, as well as actual originated transactions.

But there's a different rule for determining whether you're actually covered for the purpose of having to report in the first place, and so I wanted to bring everybody's attention to that. The rule very clearly says that in order to be covered and required to report, you have to have at least 100 small business originations within each of the preceding two years. That definition of origination means what it sounds like, you have to have actually originated the product. An application is not enough and unapproved but not accepted is not enough. So, you have to have a narrower definition of what's counted to see if you're a 1071 reporter or not. And importantly, it's only new originations that count. The rule in its commentary also make clear that if you revise or expand an existing credit line, even to add new credit amounts, then that's still not a covered origination.

Origination really means a new account, changing an existing account by changing the line or extending the term or whatever doesn't count, but refinancing an existing one does count. That's an important set of nuances that I think entities on the edge of coverage or maybe on the edge of one category of compliance data or another would really need to know. So, I wanted to bring that to everyone's attention today. But there's another industry that's been the subject of a lot of I think questions that we've gotten and probably significant confusion in the industry, and that's indirect auto finance, because you have there a number of parties involved in the application and origination process of a retail installment contract for an automobile. And if the purchaser and recipient of the financing is a small business, there are questions about whether that kind of indirect auto transaction is covered by the rule or not. Joe, you've taken a look at this issue under the 1071 rule, what can you tell our audience about whether indirect auto is in or out and why?

Joe Reilly:

There is a clear answer to that question, although you have to dig into the rule’s preamble to find it in black and white. The answer is that the indirect lender is out. And the way to understand this in terms of the rules, text and commentary I think is to go to Section 109(a)(3), which addresses which financial institution should report when there are multiple financial institutions involved in the credit decision. Which just to take indirect auto as an example certainly can happen where you have the dealer that is interfacing with the customer, in this case a small business, and behind the dealer there may be multiple indirect lenders, financial institutions that the dealer intends to sell the credit contract to. The doctrine in the rule is that in that kind of situation the only reporting entity is going to be the last covered financial institution with the authority to set the material terms of the contract.

Material terms just means what you would think it means, selecting among competing offers, modifying pricing information, et cetera. I want to go back to the word authority, now, I said only the last covered financial institution with the authority to set the material terms reports. The word authority is very important because it really doesn't matter, to go back to our dealer example, it really doesn't matter if the dealer modifies the terms that it gets from one of its indirect lenders or not. What matters is whether the dealer has the authority to set those terms. So, you can have a situation where the dealer forwards an application to an indirect lender and the indirect lender comes back and says, I'll fund this at a certain interest rate. You can have a situation where the dealer accepts that interest rate and that's the interest rate agreed to with the

customer, and it is still going to be the dealer that is going to report that transaction because even though the dealer accepted the interest rate identified by the indirect lender, the dealer still had the authority to set the material terms of the transaction.

So, the dealer is the reporter, I will just point listeners if they want to get into more detail, this is covered in two specific comments to Section 109(a)(3), they are comments 2.vii and .viii. And those make very clear that the indirect lender is not going to report the transaction under several scenarios. One last point to make is that the CFPB recognizes that one result of this approach is that there are going to be some transactions that are not reported at all, because an entity that is primarily involved in the sale or leasing of motor vehicles is of course exempt under the Dodd-Frank Act from the CFPB's rules. So, in situations like the one I was describing where you have a true auto dealer being the last institution with the authority to set the material terms, the transaction will go unreported.

Chris Willis:

Thanks a lot, Joe. That's very complicated but very important for the lending community to understand, so thanks for walking us through that. And there's another product that I'd like to talk with you about, Mark, and that is merchant cash advance. There's a lot of question about whether merchant cash advance is a credit product and whether it should be covered by a rule like this? But it's patently obvious that the bureau intended to include merchant cash advance from the inception of this rulemaking, and in fact has lots of provisions in 1071 to try to adapt the reporting fields to a merchant cash advanced product. Can you give the audience your thoughts about sort of the inclusion of merchant cash advance in the rule?

Mark Furletti:

At the outset I will say that the CFPB paints a pretty bleak picture of merchant cash advances, and I also think they struggle with defining what exactly is a merchant cash advance. But in any event, the definition of a covered credit transaction just means an extension of business credit that is not an excluded transaction, and merchant cash advances are not an excluded transaction. The coverage of MCAs is actually relegated to a comment, and it's a comment to that term covered credit transaction. It's very simple, it just says covered credit transaction includes all business credit including dot, dot, dot, merchant cash advances, and that's it. We don't get a definition of MCA anywhere, so then when you start reading the preamble, which I think will be helpful not just for people who enter into MCA transactions, but also people who might be thinking about other more exotic credit products and whether they might be covered under Reg Z or even under other federal laws with similar definitions of credit like the FCRA. You get the impression that there were a lot of people who submitted very negative comments on MCA.

In fact, I think oddly enough there were comments submitted not just by consumer and small business advocacy groups, but also small business lenders, those in the business of extending credit directly. So, the CFPB kind of paints this portrait of them that these involve a transaction where there is an obligation to repay. They don't at all touch on how that obligation in a properly structured transaction should be contingent. They observe that MCAs are used disproportionately by minority owned businesses in an attempt to justify why it's appropriate for them to be covered. They go so far as to claim that MCA companies threatened physical violence to small businesses that obtain these transactions. I've counseled clients on MCAs, I am not aware that this is something that happened often, I'm somewhat surprised by it. I mean,

I could see a really bad provider doing that potentially, but I don't think that's widespread at all. They also claim that MCA companies exploited merchants during the pandemic recovery.

And then the CFPB makes the argument that, look, almost everyone we talk to except the MCA providers themselves and MCA provider trade groups thought that they should be covered. And so they cited community groups, and small business groups, and industry and trade associations of lenders, and then lenders themselves including online lenders. So, the record here that they're creating paints a really bad picture of them. And at times I think some of these things, it's not clear what data it's based on or exactly what kinds of MCAs they were looking at. They repeatedly suggest and think about MCAs as being used by consumers. I don't think that the vast majority of them, or at least the kind of ones offered by more reputable companies are, but they gave an example of a monthly payment on a merchant cash advance that was equal to 400% of someone's take home pay.

It is unusual to see MCA transactions that are based on take home pay, normally they would be based on a business's right to future receivables, which is not the same as take home pay. So again, it seems that they were finding examples to cite in the rule from providers that are doing maybe consumer purpose MCAs, which are in my view not really MCAs. The commenters requested that the CFPB define merchant cash advance, but they refused to do so. They also rejected an argument that MCAs are a species of factoring, which is kind of what the argument has been as to why they shouldn't be deemed credit or involved debt in the past. I think the interesting part of the preamble kind of lays out the key factors why the CFPB thinks that merchant cash advances even I think properly structured ones should be deemed credit.

And I think their key reason is they don't see there being what they call a contemporary exchange of real value at the time a merchant enters into this. So, basically what the CFPB seems to be saying is, hey, when the merchant is executing the MCA agreement and selling their receivable, they actually have nothing at that moment that they're selling, unlike a transaction where I'm saying, hey, I'll buy a car and I pay money to a seller and the seller gives me a car, so the money is flowing from party A to party B, and then the car is flowing from party B to party A, and that's a contemporary exchange of real value. The CFPB is saying that's not happening here because the one party is giving money, the MCA company is giving money to the merchant, so there's value flowing there. But what's flowing back? There's no real value to that unless or until in the future the receivable is created.

And so they say that this lack of contemporary exchange of value, this kind of non-existent asset that is being handed over is not sufficient. And so therefore that kind of trips it into being a credit product. And if there was something that the merchant was selling, then it would be different. They also asserted that basically where the merchant gets money and then has the right to defer repaying that money that comes squarely within the teeth of the definition of credit under Reg B, they didn't really address the contingent nature piece of it. And then finally, and I think this is instructive again for looking possibly at other products, they said, well, on top of all this we think that there's just too many similarities between loans and MCAs generally, and so they pointed to these factors like MCAs are underwritten like loans. The source of payment for the merchant is similar for loans and MCAs.

The merchant has to repay basically what they borrowed plus additional money, which is akin to repaying the principal loan plus a finance charge. And then they also said that the repayment period, like the repayment periods on a loan can be pretty standard like either business day versus weekly, monthly, whatever, but again, kind of a predictable timeframe. It's useful because I think you can teach us something about maybe some other more exotic products and whether or not they too could be brought in. But the CFPB was very clear, no ifs, ands, or buts

MCA, however you define it is covered by the rule. And then as you said Chris, they went to great lengths to try to help people understand how to report them.

Chris Willis:

Thanks, Mark. And it's really interesting, we'll have to see what the potential fallout is if any of the points you made may give rise to a legal challenge to the coverage of MCAs under the rule. And also the other point you made about, well, if MCAs are covered, what else is covered? And the future interpretation of that. So, we'll obviously have to stay tuned for that. Let me shift gears now and let's talk about some of the challenges that we perceive to exist with particular aspects of reporting data under the rule for a lender that is a 1071 reporter. The first one that I wanted to point out is one that I think is likely to trip up some small business lenders, because the rule contains a very clear statement that an inquiry or pre-qualification request is not a reportable 1071 application, even if it may be an application for the purpose of giving an adverse action notice under Reg B.

And so that seems like a really clear, easy to rely on statement that people will say, okay, fine, inquiries and pre-qualification requests aren't covered. And I'm afraid people will just stop reading at that point and miss the very high amount of nuance that is behind that statement in the rule. Because the official commentary of the rule goes on to say that even though inquiries and pre-qualification requests aren't covered, if you have a situation where the lender requires the applicant to go through the pre-qualification process as part of the application for a credit product and gathers information about the applicant and reaches a decision or a tentative decision and says either you're declined or you're probably going to be declined, that it may be a reportable transaction under section 1071. And the Bureau goes on to basically say that this is a very fact intensive determination about whether it's covered by 1071 or not.

And the Bureau even talks about it again in the small entity compliance guide that came out most recently giving a couple of examples but still preserving this inherent ambiguity of whether a particular practice is covered or not. And it strikes me as being one of the most significant ambiguities in the rule that if lenders have pre-call processes that are built into and are mandatory part of the application processes, they'll have a real question about whether the results of those pre-call requests are reportable under 1071 or not. And again, we can't give a bright line rule to it because the CFPB hasn't given a bright line rule to it. But I wanted to alert our listenership to the fact that there's a major ambiguity there that individual lenders may have to grapple with as they decide how to comply with the rule.

But let me now shift to another potentially challenging area under the rule, and that is the use of freeform text fields. It'd be one thing if the rule required the collection of information by consumers just checking boxes in specific categories, but there are quite a few provisions of the rule that mandate that the applicant has to be free to fill in text in a freeform field that's then gathered and reported by the small business lender. And Christine, would you mind talking to the audience about where we see that in the rule and what challenges may attend it?

Christine Emello:

Sure. There are a number of data points that allow a response via freeform text box, including credit type, credit purpose, denial reasons, pricing and principal owners, ethnicity, race and sex. And for most of these data points, the lender does not need to verify the applicant data or what the applicant puts in these freeform text boxes, they can just pass it through to the CFPB. But that's not the case for credit purpose. The commentary to the rule states that if the applicant fills out in the freeform text box a purpose or purposes that are similar to purposes on the list but

uses different language, the financial institution has to recategorize that into the purpose on the list that's correlated with that purpose that the applicant provided in the freeform text box. This means that the financial institution will have to manually review all freeform text responses in the credit purpose field. So, on top of creating a new system to collect this data, financial institutions will also have to consider how operationally they are going to review manually these responses, which is an additional burden especially for smaller lenders.

Chris Willis:

Yeah, that's a really good point, Christine, and thanks for bringing that to everyone's attention. I regard this as one of the most logistically difficult parts of the rule for small business lenders to comply with. And so it's important that you've brought that to everyone's attention. There's one other thing that I wanted to point out to folks, and it's contained actually not in the rule making release itself, but in the 1071 filing instructions guide. In that guide, which is available from the CFPB as a separate document, the Bureau sets forth not only a detailed technical specification for what the LAR file needs to look like, the loan application register, but also announces towards the end of the document that it is going to perform logical checks on LARs as they are submitted to look for errors in reporting where there's just a disconnect between the fields, where they just doesn't logically make sense that you would've put a value in one field that didn't have a matching value in another or something similar to that.

And so I wanted to bring everyone's attention to the fact that the Bureau will be doing that. But interestingly, the Bureau also provided in the filing instructions guide the actual code that it is going to use to perform these logical checks on the LARs. They've provided that code in a number of formats, and so it's available for 1071 reporters to download and integrate into their own reporting systems so that they can run the same checks the Bureau will run on the data before they submit it, and then potentially avoid back and forth with the Bureau if some of the lines in the LAR are rejected. Now, that doesn't mean that just because you pass the logical checks that everything is accurate in the LAR because it can only detect certain things, but it is I think a helpful step to be able to do, and it's good that the CFPB has released that code and made it available to the industry to, as I said, incorporate into their own processes. There's another helpful thing though that I think it's important for us to tell the lending community about, and that is what I call the free look period for gathering 1071 data in the course of small business loan applications. Joe, do you mind telling our listeners about what I've dubbed the free look period?

Joe Reilly:

Absolutely, Chris. This is a special transition rule that the regulations contain at Section 114(c), and what the free look period says is that starting 12 months before your compliance date, so if you turn out to be a tier one reporter, this would be 12 months before October of 2024, you can actually begin collecting data under the rule, including the demographic data required by the rule that Regulation B ordinarily prohibits lenders from collecting. So, this is special permission to begin collecting data such as whether the applicant is a minority owned business, as well as the ethnicity, race, and sex of applicant’s principal owners. There are a number of reasons why a reporter may want to take advantage of this free look period beginning 12 months before the compliance date, it would probably benefit a reporter to do some testing on its data and storage systems, make sure that it can collect data in accordance with the rule.

But maybe most importantly, I think reporters want to think about the anti-discouragement provisions under the rule. I think listeners will recall that while the rule removed the proposal for

lenders to record demographic data by visual observation, the rule does impose an affirmative obligation to use reasonable procedures that will result in the collection of data. And the Bureau in addition to the rule published a separate statement that it is going to be prioritizing resources to determine whether lenders do have those reasonable procedures in place. And for example, the Bureau may be looking at peer data to determine if there are outliers where a particular lender may not be getting response rates about demographic data in comparison to its peers. The Bureau indicated that it would be prioritizing supervision and enforcement resources with respect to a lender like that. So, the free look period gives lenders a chance to begin collecting this demographic data and see how successful the collection is, whether the response rates are what the lender would ordinarily expect to receive, what the CFPB expects to receive. So, I think, Chris, we expect a number of lenders to take advantage of this free look period regardless of the tier that they're under.

Chris Willis:

Thanks a lot, Joe. And to me, I just want to underline that I think it makes a lot of sense. If you're wondering how to integrate the collection of the 1071 data into your application flow, the free look period gives you an opportunity to try different ways of doing it at different junctures in the application process and presenting it in different ways to try to smooth out the application experience as much as possible, but also achieve as Joe, you noted, the response rates that the CFPB is obviously so concerned about with the discouragement provisions of the rule. So, thanks for highlighting that. Let me thank both Mark and Christine also for joining us on today's episode on this sort of grab bag of issues under 1071. And of course, thanks to our audience for tuning into today's episode. Don't forget to visit our blog at consumerfinancialserviceslawmonitor.com, and hit that subscribe button so that you can get a digest of all the daily updates we post about the world of consumer finance. And while you're at it, head over to troutman.com and add yourself to our Consumer Financial Services email list, so you'll get alerts that we send out and invitations to our industry only webinars. And of course, stay tuned for a great new episode of this podcast every Thursday afternoon. Thank you all for listening.

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