Implementation Concerns of Section 1071 of the Dodd-Frank Act

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To the CFPB's November 6 Symposium on Small-Business Lending

Thank you for the opportunity to comment on the Consumer Financial Protection Bureau's implementation of Section 1071 of the Wall Street Reform and Consumer Protection (Dodd-Frank) Act of 2010.[1] I applaud Director Kraninger and the Bureau for their leadership on the subject of how to improve access to credit by small businesses, particularly those owned by minorities and women.

Section 1071 amended the Equal Credit Opportunity Act (ECOA) to require lenders to collect and maintain data on loan applications by small businesses. Lenders must ask small-business applicants whether they are a women- or minority-owned business, defined respectively as a business where more than 50 percent of ownership or control, and of net profit or loss, accrues to one or more women or minority individuals. Section 1071 also requires lenders to collect the following information from small-business loan applicants:

- the number and date of the application;
- the type and purpose of the credit being applied for;
- the amount of credit or credit limit applied for;
- the lender's decision on the application, and the date of that decision;
- the census tract of the applicant's principal place of business;
- the gross annual revenue of the business in the last fiscal year;
- the race, sex, and ethnicity of the principal owners of the business;
- and any additional data the Bureau deems appropriate.

My comments refer mainly to small-business loan data for banks and thrift institutions. However, my recommendations apply to banks, thrifts, credit unions, and nonbanks, to the extent they undertake the same activities and originate or hold a similar amount of small-business loans.

Regressive Effects of Financial Regulation

Data collection can improve supervision and enforcement of the enumerated consumer credit laws, including those aimed at fighting credit discrimination. On the other hand, data collection requirements can pose a substantial compliance burden on lenders, causing underwriting costs to rise and discouraging some lenders from serving certain markets. This unintended consequence can particularly affect small lenders and small loan applicants, as data collection requirements have fixed costs that are more burdensome on smaller entities.

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[1] 15 U.S. Code § 1691c-2. Small business loan data collection.

Recent small-business lending data from banks and thrifts bears out the regressive impact of financial regulation. Since passage of the Dodd-Frank Act, which introduced tens of thousands of new regulatory mandates and restrictions on financial institutions,[2] the annual growth rates of commercial and industrial, and nonfarm nonresidential, loans under $1 million have slowed down significantly (Table 1). Even excluding the recession years of 2008-2010, the growth reduction persists and is particularly pronounced for nonfarm nonresidential loans. While loans under $1 million increased a mere 3 percent between 2010 and 2018, well below the cumulative growth of GDP during that period, loans in excess of $1 million were up 80 percent.[3]

Table 1. Annual Growth Rate of Small Business Loans Before and After the Dodd-Frank Act

	C&I		Nonfarm, Nonres.	
Loan Amount	1996-2007 avg. growth %	2010-2019 avg. growth %	1996-2007 avg. growth %	2010-2019 avg. growth %
<$100K	5.4%	2.6%	-2.3%	-7.1%
$100K-250K	4.7%	1.6%	5.1%	-3.8%
$250K-1M	5.9%	1.1%	8.3%	-2.0%
<$1M	5.5%	1.9%	6.1%	-2.6%
All loans	6.3%	7.6%	8.6%	3.6%

Source: Federal Deposit Insurance Corporation, "Aggregate Time Series Data: Loans to Small Businesses and Small Farms," Q2 2019. Available at https://www5.fdic.gov/idasp/advSearch_warp_download_all.asp?intTab=4. C&I refers to commercial and industrial loans; nonfarm, nonres. refers to nonfarm nonresidential loans.

According to data from Community Reinvestment Act (CRA) assessments, the share of small-business bank loans going to businesses with annual revenues of $1 million or less has also declined significantly since 2010. Whereas these businesses accounted for 43.8 percent of small-business loans in 2006, their share was just 35 percent in 2017 (Table 2a). Firms applying for loans below that amount in low-income census tracts have been particularly affected by this decline, with their share of small-business loans declining from 37.4 percent to 28.4 percent between 2006 and 2017 (Table 2b).

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[2] Patrick McLaughlin, Oliver Sherouse, and Daniel Francis, "Dodd-Frank is One of the Biggest Regulatory Events Ever," Mercatus Center at George Mason University, August 31, 2017. Available at https://www.mercatus.org/publications/regulation/dodd-frank-one-biggest-regulatory-events-ever.

[3] Michael D. Bordo and John V. Luca, "The Impact of the Dodd-Frank Act on Small Business," NBER Working Paper 24501 (April 2018), 3. Available at https://www.nber.org/papers/w24501.pdf.

Table 2a. Amount and Share of Small-Business Loans to Businesses with Annual Revenues of Less than $1 Million

Year	Dollar Volume ($000)	Percent
2017	84,946,226	35.0
2016	84,814,952	33.1
2011	73,662,636	37.3
2006	133,875,641	43.8
2001	102,546,266	45.6

Source: Federal Financial Institutions Examination Council, "CRA National Aggregate Reports," 2019. Available at https://www.ffiec.gov/craadweb/national.aspx.

Table 2b. Amount and Share of Small-Business Loans to Businesses with Annual Revenues of Less than $1 Million by Census Tract Median Income

Income Level	2017		2016		2011	
	$000s	%	$000s	%	$000s	%
Low	4,166,998	28.4	4,117,626	28.2	2,444,189	29.6
Moderate	14,307,392	32.0	13,955,043	30.5	11,142,825	33.0
Medium	31,711,284	35.2	32,915,238	33.6	33,216,745	38.5
Upper	33,296,475	37.5	32,629,241	34.7	26,457,500	39.4
Income Level	**2006**		**2001**		**1996**	
	$000s	%	$000s	%	$000s	%
Low	4,688,997	37.4	3,959,459	36.6	2,909,614	35.3
Moderate	20,892,535	40.3	14,027,575	41.4	10,077,315	41.4
Medium	59,391,810	45.1	49,846,079	47.1	31,078,806	44.5
Upper	46,972,331	44.9	33,112,637	47.0	20,202,601	43.6

Source: FFIEC, "CRA National Aggregate Reports," 2019.

Some scholars have linked the decline of small-business lending to a reduction in the number and market share of community banks, which accelerated after passage of Dodd-Frank.[4] Complementary evidence suggests that bank consolidation may lead to a prolonged decline in small-business lending in the areas served by the acquired bank.[5] Other scholars point to a large and persistent drop in small-business lending by the largest banks during and after the last financial crisis.[6] Both hypotheses, however, are consistent with a constrained post-crisis bank credit environment for small businesses,

[4] Marshall Lux and Robert Greene, "The State and Fate of Community Banking," Mossavar-Rahmani Center for Business and Government Associate Working Paper No. 37 (February 2015), 17-18. Available at https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf.

[5] Julapa Jagtiani and Catharine Lemieux, "How Important Are Local Community Banks to Small Business Lending? Evidence from Mergers and Acquisitions," Federal Reserve Bank of Philadelphia WP 18-18 (August 2019), 16-17. Available at https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2018/wp18-18.pdf?la=en.

[6] Brian S. Chen, Samuel G. Hanson, and Jeremy C. Stein, "The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets," NBER Working Paper 23843 (September 2017), 2. Available at https://www.nber.org/papers/w23843.pdf.

in which the share of small-business loans in all bank loans has dropped from half to less than a third.[7]

Nonbank fintech lenders have plugged the gap to some extent. According to the Federal Reserve regional banks, 32 percent of small-business loan applications in 2018 were to online lenders.[8] Furthermore, medium- and high-risk applicants, who may be relatively less well-served by traditional credit institutions, are three times more likely to apply to an online lender.[9] These survey results are consistent with empirical evidence that fintech lenders tend to serve markets with less competition among banks and fewer bank branches.[10]

The Bureau should be aware of small-business lending trends as it prepares a rulemaking for Section 1071. Increasing compliance costs on small-business lenders is unlikely to benefit business loan applicants, particularly startups and those from underserved communities. The Government Accountability Office noted in its 2012 report on the impact of Dodd-Frank that "section 1071 was . . . identified by regulators and industry representatives as potentially having a direct impact on small business lending by community banks and credit unions."[11] The regressive impact of excessively burdensome data collection requirements will only become greater in a downturn, as lenders tighten credit standards and look to keep operating costs down.

Suggested Ways to Reduce Section 1071's Implementation Cost

The Bureau can achieve the purpose of Section 1071 – "to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs of women-owned, minority-owned, and small businesses"[12] – while minimizing a counterproductive reduction in small-business credit supply due to higher compliance costs. It can do so by tailoring the rule's definitions and by using its exemptive authority to relieve low-volume lenders, and those

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[7] Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Harvard Business School Working Paper 15-004 (July 2014), 5. Available at https://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf.

[8] Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis, and San Francisco, "Small Business Credit Survey," Report on Employer Firms, 2019, 16. Available at https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf.

[9] Ibid.

[10] Julapa Jagtiani and Catharine Lemieux, "Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?," WP 18-13, Federal Reserve Bank of Philadelphia (March 2018), 10 ff. Available at https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2018/wp18-13.pdf?la=en.

[11] Government Accountability Office, "Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings," GAO-12-881, September 2012, 67. Available at https://www.gao.gov/assets/650/648210.pdf.

[12] 15 U.S. Code § 1691c-2(a).

who perform well according to existing financial inclusion assessments, from data collection requirements.

Exempt banks, thrifts, and credit unions under $1 billion in assets

Section 1071 gives a broad definition of a financial institution: “any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity.”[13] But the statute also gives the CFPB broad scope to exempt financial institutions from its data collection requirements: “the Bureau . . . may conditionally or unconditionally, exempt any financial institution or class of financial institutions from the requirements of this section, as the Bureau deems necessary or appropriate to carry out the purposes of this section.”[14]

The Bureau should use this authority to exempt institutions that represent a small share of small-business lending, but for whom the additional compliance burden from Section 1071 may be especially onerous. Small financial institutions are an example.

As of the second quarter of 2019, there were 1,230 banks and thrifts with assets under $100 million reporting to the Federal Deposit Insurance Corporation (FDIC). They accounted for 23 percent of all FDIC-regulated institutions. But their share of small-business loans outstanding is extremely small: 1.47 percent by dollar volume, and 0.61 percent by number of loans (Table 3). Banks and thrifts with assets between $100 million and $1 billion account for 62 percent of FDIC member institutions, but only 9.2 percent of small-business loans. Finally, all banks and thrifts under $10 billion in assets account for 43.8 percent of small-business loan volume but only 17.4 percent of the number of loans.

Table 3. Small-Business Loan Volume and Number, FDIC-Regulated Institutions, by Asset Size

Institution Asset Size	<$100M	$100M<$1B	$1B<1$10B	>$10B
Loan Volume $	9,479,574	138,348,884	134,285,801	362,405,976
Loan Volume %	1.47	21.47	20.84	56.23
Loan Number	143,245	2,147,773	1,781,287	19,369,854
Loan Number %	0.61	9.16	7.6	82.63

Source: Federal Deposit Insurance Corporation, “Statistics on Depository Institutions,” Q2 2019. Available at https://www5.fdic.gov/sdi/main.asp?formname=compare. Loans are Commercial & Industrial and Nonfarm Nonresidential loans by FDIC Member Banks and Savings Institutions.

In loan data collection, there is clearly a tradeoff between compliance cost and comprehensiveness. A sound cost-benefit analysis can establish the right margin at which to set an asset-size exemption. From the most recent data, however, it would seem reasonable to set a *de minimis* threshold of $1 billion, as such a threshold would

[13] 15 U.S. Code § 1691 c-2(h)1.
[14] 15 U.S. Code § 1691 c-2(g)2.

relieve the smallest 85 percent of banks and thrifts, while removing loan data on just 23 percent of small-business loans by volume and 9.8 percent by number.[15] Because the aim of Section 1071 is to collect information on loan applicants, the *number* of loans held by each category of institutions is the more relevant measure.

Regarding credit unions, those above $500 million in assets represent just 11 percent of institutions but account for 85 percent of commercial loans. Credit unions above $1 billion in assets account for 30 percent of loans but just 6 percent of institutions (Table 4). An exemption for credit unions should seek equity with banks and thrifts. I therefore recommend a $1 billion exemption. However, even a $500 million exemption would cover nearly 90 percent of the smallest credit unions and save them what can potentially be an onerous compliance burden for very low loan volume.

Table 4. Credit Union Commercial Loan Volume and Share, by Asset Size

	Loan $ Volume	% Loan Volume	Number Institutions	% Institutions
All	77,296,305,476	100	5368	100
<$1B	23,207,435,476	30.02	318	5.92
<$500M	11,515,041,069	14.90	583	10.86

Source: National Credit Union Agency, June 2019.

Exempt CRA-regulated institutions with a "satisfactory" rating or higher

Another low-risk way to reduce compliance cost among financial institutions would be to exempt those that perform well by existing financial inclusion evaluations. The Community Reinvestment Act has since 1977 required regulators "to use [their] authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[16] The CRA applies to depository institutions other than credit unions and is enforced by the three banking regulators: the FDIC, the Board of Governors of the Federal Reserve, and the Office of the Comptroller of the Currency.

These regulators have since the mid-1990s implemented the CRA by evaluating banks and thrifts according to their lending, investment, and service activity in the areas where they operate branches, offices, or automated teller machines (ATMs). The lending component of CRA assessments is the weightiest and it evaluates mainly mortgage, small business, and small farm lending.[17] Banks below $1.284 billion (as of 2019) face less onerous and frequent CRA evaluations.[18] However, if the CFPB implemented a $1

[15] Note that the higher share of small banks in loan volume than number means their average loan is larger.
[16] 12 U.S. Code § 2901(b).
[17] FFIEC, "Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestment," 66 Fed. Reg. 36639, 33640 (July 12, 2001). Available at https://www.govinfo.gov/content/pkg/FR-2001-07-12/pdf/01-17246.pdf.
[18] Diego Zuluaga, "The Community Reinvestment Act in the Age of Fintech and Bank Competition," Cato Policy Analysis No. 875 (July 2019), 3. Available at https://www.cato.org/sites/cato.org/files/pubs/pdf/pa-857-updated-

billion exemption, very few institutions would be subject to both an exemption from Section 1071 data collection requirements and to a reduced CRA evaluation.

CRA lending assessments consider a bank's geographic and income distribution of loans in the census tracts where they conduct business, with particular attention to the bank's record of serving low- and moderate-income communities, defined as either census tracts where the median income is below 80 percent of the area median, or borrowers whose median income lies below that threshold.[19] As of late October 2019, the three CRA regulators are expected to soon deliver a proposal on changes to their CRA assessment procedures.

Because of the CRA's longstanding focus on financial inclusion in small-business lending, and the banking regulators' comparative expertise in overseeing this type of credit, I propose to exempt from Section 1071 all CRA-regulated institutions with a CRA score of "satisfactory" or higher.

CRA regulations describe "satisfactory" performance as demonstrating at least an adequate distribution of loans across census tracts and income levels, among other factors.[20] Of the 179 large banks evaluated for the CRA in 2018, 176 obtained a "satisfactory" or "outstanding" rating. Just three large banks were rated below that score. Similarly, CRA regulators rated just two out of 157 large banks evaluated in 2017 as "needs to improve," while one was found in "substantial noncompliance." Of the 67 large banks examined so far in 2019, none is below "satisfactory."[21]

If the CFPB would not like to exempt most large banks from Section 1071, it could reduce the scope of the exemption to the top performers. A less comprehensive exemption might, for example, include only banks that score "outstanding" in their CRA evaluations – around 10 percent in any given period[22] - or those with a "high satisfactory" score on the lending component of large bank CRA evaluations.[23]

Collect only the data points mandated by the statute

Section 1071 mandates the Bureau to collect seven different categories of data on each small-business loan application. They include census tract of the applicant's principal

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2.pdf. As of January 2019, the asset thresholds for "small" and "intermediate small" institutions exempt from the full CRA evaluations were $1.284 billion and $321 million, respectively. See FFIEC, "Explanation of the Community Reinvestment Act Asset-Size Threshold Change." Available at https://www.ffiec.gov/cra/pdf/AssetThreshold2019.pdf.

[19] Ben Horowitz, "Defining 'Low- and Moderate-Income' and 'Assessment Area,'" in *Community Dividend* (Minneapolis: Federal Reserve Bank of Minneapolis) March 8, 2018. Available at https://www.minneapolisfed.org/publications/community-dividend/defining-low--and-moderate-income-and-assessment-areas.

[20] 12 C.F.R. 25 App. A(b).

[21] FFIEC, "Interagency CRA Rating Search," 2019. Available at https://www.ffiec.gov/craratings/default.aspx.

[22] Darryl E. Getter, "The Effectiveness of the Community Reinvestment Act," Congressional Research Service, January 7, 2015, 9. Available at https://www.newyorkfed.org/medialibrary/media/outreach-and-education/cra/reports/CRS-The-Effectiveness-of-the-Community-Reinvestment-Act.pdf.

[23] 12 C.F.R. 25 App. A(b)(1)(ii).

place of business, as well as the loan amount applied for, and the lender's decision on the application. In addition to the cost of complying with these data requirements, which experience with the Home Mortgage Disclosure Act (HMDA) suggests can be considerable, there are serious privacy concerns around such detailed collection of personal information that could enable malicious actors to identify loan applicants.

According to the U.S. Census Bureau, the average number of residents in each census tract is 4,000, with the regulatory minimum being 1,200 and the maximum 8,000.[24] With such a small sample size, it would not be difficult for a hacker who gained access to the CFPB database to guess the identity of individual loan applicants. This information could then be used for financial fraud purposes and to damage the reputation of loan applicants – by, for example, suggesting a loan rejection is evidence of poor financial condition.

Government agencies have previously raised the topic of data protection within the CFPB, warning about potential risks.[25] Privacy risks would also inevitably arise from requiring financial institutions to collect, report, and hold loan applicant data on a regular basis. At a minimum, the CFPB should not increase such risks by increasing the scope of data collection requirements, which could facilitate malicious activities.

Define a "small business loan" as a loan under $1 million to a business with annual revenue under $1 million

Advocates for the application of consumer protection regulations in small-business lending argue that applicants for low-value small-business loans are the same type of borrowers, and therefore face similar informational and other barriers, as consumer loan applicants.[26] The small-business owners who will most frequently apply for lower-value loans usually require a rudimentary knowledge of bookkeeping and financial management that non-business consumers may lack, so it is not obvious that both types of applicants face the same constraints.

However, even conceding the argument, it only applies to comparably lower-value business loan applications. Larger businesses will have specialist staff who manage company finances, and larger loan applications will require greater documentation by the business applicant about its financial situation, business plan, growth opportunities, and other important criteria that will give the applicant and the prospective lender more information than would be available to a consumer applicant. It therefore makes sense to restrict the businesses and loan applications subject to Section 1071 to the more

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[24] U.S. Census Bureau, "Census Tracts," Geographic Products Branch. Available at https://www2.census.gov/geo/pdfs/education/CensusTracts.pdf.

[25] Government Accountability Office, "Consumer Financial Protection Bureau: Some Privacy and Security Procedures for Data Collections Should Continue Being Enhanced," GAO-14-758 (September 2014), 56 ff. Available at https://www.gao.gov/assets/670/666000.pdf.

[26] Lenor Palladino, "Small Business Fintech Lending: The Need for Comprehensive Regulation," *Fordham Journal of Corporate and Financial Law* Vol. XXIV, 79. Available at https://news.law.fordham.edu/jcfl/wp-content/uploads/sites/5/2019/03/Palladino-Article.pdf.

vulnerable applicants. I propose defining a “small business” as a business with less than $1 million in revenue, and a “small business loan” as a loan in an amount below $1 million. Where a small-business has not been in operation for a full year before applying, just the $1 million-dollar loan threshold would apply.

The evidence around small-business loan trends supports the proposed definition. While small-business loans in excess of $1 million have grown by more than 80 percent since 2010, loans under that figure have grown by just 3 percent.[27] The share of small-business loans under $1 million in all small-business loans has declined as a result, and it is particularly small in low- and moderate-income census tracts (Table 2). A policy that seeks to help “identify business and community development needs of women-owned, minority-owned, and small businesses,”[28] as is the case with Section 1071, should focus on the part of small-business lending that appears to have struggled to recover since the financial crisis. Furthermore, a $1 million loan threshold would still cover 92 percent of applications.[29]

Avoid Driving Lenders Away from Underserved Credit Markets

The empirical evidence suggests that regulatory costs have made it more difficult for many depository institutions to continue to lend to small businesses, especially for amounts below $1 million. As it considers ways to implement its statutory mandate under Section 1071, the CFPB should make it a top priority not to worsen this post-crisis phenomenon by increasing the regulatory costs associated with small-business lending.

To that end, I recommend that the Bureau exempt all banks, thrifts, and credit unions with assets below $1 billion from Section 1071’s data collection requirements. Because the compliance cost would be highest to them for a small incremental gain from data collection, I believe it is suitable to exempt them.

Additionally, I propose that the CFPB rely on the expertise of Community Reinvestment Act regulators, by exempting from Section 1071’s requirements those institutions found to adequately meet the CRA regulations, which assess banks and thrifts’ small-business lending record, among other activities. An exemption for all institutions with an overall “satisfactory” CRA rating would be appropriate, while a more limited exemption might include institutions with an “outstanding” rating or those which earn a “high satisfactory” rating on the lending component of their CRA assessment.

I also recommend that the Bureau not add data points to those required by the statute, as this would increase regulatory costs to reporting institutions and potentially compromise applicant privacy. Finally, I propose defining a “small business” as a business with less than $1 million in revenue in the previous fiscal year, and a “small business loan” as a loan under $1 million. These definitions address Section 1071

[27] Bordo and Luca, “The Impact of the Dodd-Frank Act on Small Business,” 3.
[28] 15 U.S. Code § 1691c-2(a).
[29] Federal Reserve Banks, “Small Business Credit Survey,” 10.

proponents’ concerns, while restricting the compliance burden to those small-business loans that merit such concerns.

Thank you again for the opportunity to offer my comments to the Bureau. I look forward to discussing these issues further at the Nov. 6 symposium.