CLFP Recertification | 2024

Section 1071 of the Dodd-Frank Act

Timeline

- If the financial institution has 2,500 or more covered transactions, data collection begins on 10/1/24, and the initial filing date is set for 6/1/25.
- For financial institutions with 500-2,499 covered transactions, data collection starts on 4/1/25, and the initial filing date is 6/1/26.
- And for financial institutions with 100-499 covered transactions, data collection begins on 1/1/26, and the initial filing date is scheduled for 6/1/27.

Background of 1071

Section 1071 of the Equal Credit Opportunity Act (ECOA) requires financial institutions to gather and report data on business credit applications to the Consumer Financial Protection Bureau (CFPB). The purpose of this requirement is to support fair lending enforcement and identify needs for women-owned, minority-owned, and small businesses. The CFPB can request additional data points if deemed necessary. The final rule, issued by the CFPB, mandates covered institutions to collect and report data on small business applications and enables the creation of a comprehensive public database on small business lending practices. Financial institutions, including all those involved in commercial finance activities like equipment leasing and finance companies, have a responsibility to determine if their customers qualify as small businesses.

Potential compliance issues

Incomplete Reporting: All covered transactions must be reported accurately. Failing to do so may raise concerns and give the impression that applicants have been discouraged from providing demographic information. The CFPB has emphasized this as an examination priority.

Procedural Formalities: Having well-defined and documented application procedures is crucial for compliance. Lack of formal processes can create vulnerabilities that may be identified during audits or examinations.

Transparent Pricing Decisions: It's important to clearly document the reasons behind pricing decisions.

Underwriting and Exception Rates: High rates of underwriting and pricing exceptions can be red flags for compliance issues.

Fair Lending Testing and Monitoring: Establishing robust mechanisms for fair lending testing and monitoring is crucial to identify and rectify any potential compliance gaps.

Additionally, the CFPB has set up a resource center where institutions can seek guidance and submit questions. However, it's important to note that queries may not be anonymous, so users should be aware of the likelihood of their identity being disclosed.

Data Required

Data collection for covered transactions involves approximately 81 data fields, which must be formatted according to CFPB specifications. Establishing robust procedures for data collection is recommended to ensure compliance and withstand scrutiny. Financial institutions are not required to verify applicant information, but if verification is done, it must be reported to the CFPB. Certain previously collected applicant data may be reused within a year, while demographic data may be collected every 36 months.

Demographic information collected by loan officers must be separated from underwriters, except in cases where it's deemed infeasible, with appropriate customer notice. Implementing these changes requires resource allocation for software collaboration, role redefinition, workflow adjustments, and organizational adaptability. Larger institutions with geographically dispersed loan officers and underwriters may face challenges in maintaining this separation. Software solutions can help segregate demographic information while ensuring underwriting requirements are met. Adapting to these process changes enables effective data management and compliance with the final rules.

Sources of Funding/Capital Allocation

Capital Allocation

In March 2023, three U.S. banks failed, two of which were among the 30 largest U.S. banks at that time. The fallout from those failures has prompted lenders and lessors to carefully consider their capital bases, sources of capital, and risk/reward appetite.

What went wrong with the banks that failed? According to the U.S. Government Accountability Office, the primary drivers include:

1. Limited market focus and rapid growth

Over the period from December 2018 to December 2022, one institution's assets more than doubled, while another's more than tripled. Rapid growth by any company, regardless of the industry, requires a strong and reliable capital base. These two institutions funded their growth primarily with deposits uninsured by the FDIC. While individuals and consumers consider a deposit an asset, banks view deposits as liability accounts, as they are obligated to return the funds to depositors when they want their money back.

Certain industries can experience rapid growth during various economic climates. For example, during the height of COVID, technology became increasingly important as employees and students were sent home to work and study virtually. Further back in history, real estate also grew rapidly. When the economy changes, companies actively involved in certain industries can be significantly impacted to the point that they need to withdraw their deposits to pay their bills.

As these banks expanded their assets (loan portfolios and investment portfolios), their reliance on stable deposits became more important. Unfortunately, when multiple depositors rushed to withdraw funds, the institutions did not have the liquidity readily available to satisfy the requests. While the impact was felt most by a few institutions, the entire banking industry was affected due to concerns of more withdrawals simultaneously and the potential for a repeat of the run on banks during the Great Depression.

2. Investment portfolio and rapidly increasing interest rates

When interest rates rise, certain investments (such as long-term bonds earning a lower interest rate compared to newly-issued bonds at a higher interest rate) can lose value because there is little interest from others to purchase lower-rate investments. Even if an investor has no intention of selling such investments and plans to hold them until maturity, the value of the investment declines. In a scenario where depositors wish to withdraw their deposits, a financial institution might be forced to liquidate its investments into cash at a loss, potentially a significant one.

While there are investment strategies to reduce risks associated with rapidly rising or declining interest rates, this risk management strategy comes at a cost and seems to not have been appropriately employed by some institutions.

Regulatory requirements mandate that certain large banks identify unrealized losses in their investment portfolios, which diminishes their regulatory capital position. Following the March 2023 bank failures, the industry has focused on building capital and allocating it to the most profitable opportunities. Additionally, an international regulatory requirement known as Basel III, developed after the 2007-2009 financial crisis, is anticipated to lead to increased capital requirements for banks.

In order to increase capital, companies primarily retain earnings and/or issue stock. To enhance earnings for retention, companies strive to improve profitability through higher revenues and/or lower expenses. Banks aim to bolster earnings by earning more on their loans and leases (revenues) and minimizing losses (charge-offs) and lowering expenses. This inevitably leads to tighter credit parameters and higher rates for the use of the bank's capital.

Reference material: "March 2023 Bank Failures—Risky Business Strategies Raise Questions About Federal Oversight" by U.S. GAO

Synthetic Identity Theft

Definition:
Fraudsters create synthetic identities by piecing together fictitious and/or stolen personally identifiable information to forge an identity, with the intent of engaging in deceitful activities for personal or financial gain. These fraudsters utilize these fabricated identities to establish fictitious companies or steal the identities of existing businesses. This allows them to open bank accounts and/or secure loans, further enabling their financial schemes.

The Impact:
According to the Federal Reserve, Synthetic Identity Theft led to approximately $20 billion in losses for U.S. financial institutions in 2020. However, this figure is likely an underestimate since Synthetic Identity Theft often gets misclassified as 'credit losses,' as creditors might not accurately identify the true nature of the loss.

A Benchmarking Report titled "Combatting Business-to-Business Fraud," jointly released in June 2023 by the Association of Fraud Examiners and Thomson Reuters, ranks concerns related to Synthetic Identity or fake business relationships as among the primary fraud-related worries during the onboarding of new business customers or vendors.

How the Scheme Works:
Fraudsters commonly use the synthetically crafted identity to apply for credit, introducing the false identity into the financial system. They are aware that the initial application might be rejected. However, this rejected application establishes a credit file. The fraudsters then persistently submit credit applications using this identity until one is approved. They might even apply as a co-signer with a 'qualified applicant' to increase their chances of approval. Over time, they build a favorable credit history, amassing credit limits and acquiring additional accounts. Some might continue making payments if they are using the credit history for criminal activities like human trafficking, terrorist financing, or money laundering. Others opt to 'bust out' by ceasing payments, vanishing with the loan's collateral. Remarkably, the same synthetic identity can be exploited to defraud multiple industries and institutions simultaneously.

Core Identifying Information Collection & Verification:
While collecting essential identifying information before onboarding a new business, guarantor, and/or vendor is crucial, going a step further by validating the data through third-party data providers (such as credit-reporting agencies, government databases, or reputable third-party verification sources), as well as conducting open-source internet searches and outsourcing to subscription-based service providers, becomes paramount in shielding your institution from potential losses arising from synthetic identities.

Key data points to gather may encompass, but are not restricted to, the complete legal name of the entity/individual; taxpayer identification number; beneficial ownership form; physical and mailing addresses; phone numbers; email addresses; and photo identification for all guarantors and signers (including a clear color copy of both sides).

Additional internal screenings might involve, but are not confined to, sanctions screening; corporate filing history; open-source searches (including negative news and overall web presence); and criminal and public record searches.

Fraud Detection Toolkit and Service Providers:
Numerous toolkits and solutions are accessible to aid in identifying synthetic identities. One such resource is the Synthetic Identity Fraud Mitigation Toolkit, issued by the Federal Reserve in February 2022. **Synthetic Identity Fraud Mitigation Toolkit – FedPayments Improvement**

Many traditional fraud models and tools are not designed to account for the possibility of a 'nonexistent' person, underscoring the need to thoroughly vet businesses and individuals or rely on fraud mitigation service providers to unearth these fraudulent activities.

Resources:https://www.acfe.com/about-the-acfe/newsroom-for-media/press-releases/press-release-detail?s=ACFE-TR-B2B-Fraud-Report

Benefits of Leasing

With new regulations and monitoring in our industry, there has been a shift with many organizations offering Lease Agreements instead of Equipment Finance Agreements (Loans). Along with being exempt from certain regulatory requirements, Leasing offers several benefits depending on the context and individual needs of the borrower. With the increased popularity of offering Leases, we will discuss the common advantages associated with Leasing as well as how a Lease can differ from a Loan for the Borrower.

Lower Upfront Costs: Instead of a substantial down payment, the borrower typically pays a smaller upfront fee, followed by regular monthly payments throughout the Lease term. This can make it more affordable to acquire and use assets, especially for borrowers with limited capital. Monthly payments, as well as end-of-term options, will vary depending on the type of Lease initiated.

Access to Newer Assets: Leasing enables the borrower to utilize the latest models or technologies available without the long-term commitment of ownership. This is particularly advantageous in rapidly evolving industries where technology quickly becomes obsolete. Through Leasing, the borrower can frequently upgrade to newer or more advanced assets, ensuring access to the latest features and functionalities. This can also create additional opportunities for repeat financing with valued customers.

Flexibility and Convenience: Lease terms can be negotiated to match specific requirements, such as the length of the lease period, monthly payment amount, and end-of-lease options. Depending on the Lease type, the borrower has choices to return the asset, renew the Lease, or purchase the asset at a predetermined or fair market price. This flexibility empowers the borrower to adapt to changing needs and market conditions.

Preservation of Capital and Credit Lines: Leasing enables the borrower to preserve capital for other investments or expenses. By avoiding substantial upfront payments, the borrower can maintain cash flow and liquidity. This is particularly advantageous for borrowers who wish to strategically allocate their financial resources. Additionally, leasing typically doesn't impact credit lines, leaving them available for other business or personal needs.

As organizations consider their financing options, the advantages of Leasing stand out, providing a flexible and cost-effective approach to acquiring and utilizing assets. It's essential to fully assess individual needs and financial goals to determine whether a Lease or a Loan better suits the situation.

Key Differences Between a Lease and a Loan:

Difference	Lease	Loan
Ownership	The lessor retains ownership of the asset throughout the lease term. The lessee has the right to use the asset in exchange for regular lease payments.	The borrower takes ownership of the asset or property being financed. The lender provides funds for the purchase, and the borrower repays the loan over time based on a stream of payments.
Purpose	Often used to acquire the temporary use of an asset. Common for equipment, vehicles, or technology that may become outdated or require frequent upgrades. This allows the lessee to use the asset without the long-term commitment and responsibilities of ownership.	Typically used to finance the purchase of an asset or property. Commonly used for real estate, vehicles, or large equipment, where the borrower intends to own the asset outright at the end of the loan term.
Payment Structure	Payments are typically made in regular installments over the lease term with the option of a final lease payment. The lessee pays for the use of the asset but does not build equity or ownership in the asset.	Repayments usually consist of both principal and interest calculated in one monthly payment. The borrower gradually pays off the loan over time, building equity in the asset until it's fully owned.
End of Term	There are several options, depending on the lease agreement. The asset could be returned to the lessor, the lease could be renewed for an additional term, or the lessee could exercise the option to purchase the asset at a predetermined or fair market price. When considering lease options, financial institutions should factor in the residual risk of a lease, especially with the volatility of the used equipment market currently. Additionally, the ability to remarket any returned assets should also be considered when determining what types of leases to offer the borrower.	Once the borrower completes the repayment, they become the outright owner of the asset. The borrower has full control and can use, sell, or dispose of the asset as they see fit.