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# A Snake Eating Its Own Tail: The Self-Defeating Nature of an Overly Broad Implementation of Section 1071

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# A Snake Eating Its Own Tail: The Self-Defeating Nature of an Overly Broad Implementation of Section 1071

## I. INTRODUCTION

Small businesses are the backbone of their communities.<sup>1</sup> These businesses are vital in fueling economic growth and fostering community development.<sup>2</sup> They are the primary source of income for many owners and employees.<sup>3</sup> Their successes and failures send ripple effects through their economies.<sup>4</sup>

For small businesses to succeed, they need reliable access to credit.<sup>5</sup> Community banks have “consistently served as a dedicated and essential source of credit to small firms”<sup>6</sup> and have proven to be the best and most reliable source of credit to these small businesses.<sup>7</sup> When community banks suffer, so do small businesses and the communities

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1. Gregg Fairbrothers & Catalina Gorla, *Social Value and Core Value: Small Businesses and Local Communities*, FORBES (July 5, 2012, 11:57 PM), <https://www.forbes.com/sites/greggfairbrothers/2012/07/05/social-value-and-corevalue-small-businesses-and-local-communities/#20ab0bb3424e>.

2. See CONSUMER FIN. PROT. BUREAU, KEY DIMENSIONS OF THE SMALL BUSINESS LENDING LANDSCAPE 3 (May 2017), [http://files.consumerfinance.gov/f/documents/201705\\_cfpb\\_Key-Dimensions-Small-Business-Lending-Landscape.pdf](http://files.consumerfinance.gov/f/documents/201705_cfpb_Key-Dimensions-Small-Business-Lending-Landscape.pdf) (“Small businesses play a key role in fostering community development and fueling economic growth both nationally and in their local communities.”).

3. See *id.* (“64 percent of respondents stated that their small business was their primary source of income.”).

4. Arthur E. Wilmarth, Jr., *A Two-Tiered System of Regulation is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks*, 2015 MICH. ST. L. REV. 249, 297 (2015).

5. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (“To contribute meaningfully to the U.S. economy, small businesses – and especially women-owned and minority-owned small businesses – need access to credit to smooth business cash flows from current operations and to allow entrepreneurs to take advantage of opportunities for growth.”).

6. Wilmarth, Jr., *supra* note 4, at 288; See also CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 24 (stating that small businesses continue to rely on traditional financial institutions, defined as large banks and small banks, as their primary source of financing).

7. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 24–25 (explaining that 46% of small businesses who applied for credit did so at a small community bank, 22% of small businesses rely on community banks as their primary source of credit, and small businesses are more likely to be approved for credit by a community bank than a larger bank).

they serve.<sup>8</sup> The Consumer Financial Protection Bureau (“CFPB”) has begun the rulemaking process for Section 1071 (“Section 1071”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which could threaten community banks by imposing additional burdensome compliance costs related to small business lending.<sup>9</sup>

Section 1071 amended the Equal Credit Opportunity Act (“ECOA”) to require financial institutions to compile, maintain, and report information concerning credit applications made by women-owned, minority-owned, and small businesses.<sup>10</sup> In May 2017, the CFPB took its first major step in the rulemaking process for Section 1071 by issuing a request for information (“RFI”) on the small-business lending marketplace.<sup>11</sup> The RFI seeks to collect information which will help explore potential ways to implement Section 1071 in a balanced manner with a goal of providing timely data with the highest potential for achieving the statutory objectives of facilitating enforcement of fair lending laws, while minimizing burden to both the industry and CFPB.<sup>12</sup>

The most fundamental goal of Section 1071 is to protect small businesses.<sup>13</sup> An overly broad application, however, could be self-defeating and ultimately hinder these same small businesses.<sup>14</sup> If the implementation of Section 1071 imposes too heavy of a compliance cost burden, it may cause the community banks to fail, thereby restricting access to credit for small businesses—the very businesses this law was enacted to protect.<sup>15</sup> In order to better achieve the regulatory goals of Section 1071 while not imposing undue compliance burdens on community banks, the CFPB should exercise its statutory exemption authority to exempt community banks with less than \$50 million in assets.

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8. See Fairbrothers & Gorla, *supra* note 1 (explaining that employees and their families depend on small businesses and that communities crumble without the revenue flows from these small businesses).

9. See Jeff Bater, *CFPB Starts Inquiry of Small-Business Lending*, [2017] Banking Daily (BNA) No. 90 (May 11, 2017) [hereinafter Bater, *Inquiry*].

10. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071(b), 15 U.S.C. § 1691c-2(b) (2016).

11. Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. 22318 (May 10, 2017).

12. *Id.* at 22319.

13. See *id.* (stating that a goal of Section 1071 is to identify small business needs and opportunities).

14. See *infra* Part IV.

15. See *infra* Part IV; see also Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22318 (explaining that a fundamental goal of Section 1071 is to identify small business needs and opportunities).

This Note proceeds in six parts. Part II describes the goals of Section 1071 and the issues to be addressed by the rulemaking process.<sup>16</sup> Part III examines the importance of small businesses to the economy.<sup>17</sup> Part IV explains how an overbroad implementation could cause community banks to exit the market and harm the small businesses that the rule was enacted to protect.<sup>18</sup> Part V suggests that the smallest community banks be exempted from the implementation of Section 1071 and explains how the exemption would save small community banks from significant new compliance costs.<sup>19</sup> Finally, Part VI concludes by summarizing how an overly broad application of Section 1071 could harm community banks and the potential for the suggested exemption to mitigate those potential harms.<sup>20</sup>

## II. THE GOALS AND REQUIREMENTS OF SECTION 1071

Prior to the passage of Dodd-Frank, lenders were prohibited from collecting race and gender data in connection with nonmortgage lending.<sup>21</sup> On July 16, 2007, three congressmen wrote a letter to the Government Accountability Office (“GAO”) to ask for a review of the impact of ending this prohibition.<sup>22</sup> The letter also asked the GAO to assess the possible costs of requiring banks to collect and report this type of information and review the advantages and disadvantages to banks and small businesses of amending the rule.<sup>23</sup> This was the beginning of the process of developing a rule that was eventually passed in Dodd-Frank in the form of Section 1071.<sup>24</sup>

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16. *See infra* Part II.

17. *See infra* Part III.

18. *See infra* Part IV.

19. *See infra* Part V.

20. *See infra* Part VI.

21. Richard Cowden, *Lawmakers Question Fed Ban on Collecting Race, Gender Data for NonMortgage Lending*, [2007] *Banking Daily* (BNA) No. 137 (July 18, 2007).

22. *Id.*

23. *Id.*

24. *Id.*; *see also*, Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071, 15 U.S.C. § 1691c-2 (2016) (enacting a final statute in the form of Section 1071).

A. *The Purposes of Section 1071*

The stated purpose of Section 1071 is “to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses.”<sup>25</sup> The aims of Section 1071 can be summarized into two main goals: (1) to facilitate enforcement of fair lending laws,<sup>26</sup> and (2) to compile reliable and consistent data on the small business lending market that can be used by a variety of decision makers to assess problems in the market and develop solutions.<sup>27</sup> The goals of Section 1071 should also be viewed in light of the overall purposes of Dodd-Frank, which is to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices,” among other things.<sup>28</sup>

B. *The Requirements of Section 1071*

Section 1071 seeks to accomplish its goals by requiring financial institutions to compile and maintain records of information provided by loan applicants regarding their status as women-owned, minority-owned, or a small business.<sup>29</sup> To gather this information, in the case of any application for credit, a financial institution must inquire whether the business is a women-owned, minority-owned, or small business and

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25. Dodd-Frank § 1071(a), 15 U.S.C. § 1691c-2(a).

26. *Id.*

27. *See Testimony of Elizabeth Warren Before the Comm. on Oversight and Gov’t Reform*, 112th Cong. 4 (2011) (“Congress intended Section 1071 to produce reliable and consistent data that can be analyzed by the Bureau, other government agencies, and members of the public to facilitate enforcement of fair lending laws and to identify business and community development needs.”).

28. 12 U.S.C. § 5301 (2016) (stating in the preamble that the purpose of Dodd-Frank is “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”).

29. *See* Dodd-Frank § 1071(b), 15 U.S.C. § 1691c-2(b) (explaining that Section 1071 requires financial institutions to compile and maintain records of information provided by loan applicants regarding their status as a women-owned, minority-owned, or small business).

maintain a record of the responses.<sup>30</sup> Although any applicant may refuse to provide any requested information,<sup>31</sup> each financial institution will be required to compile and maintain a record of such information provided by applicants in a manner to be prescribed by the CFPB.<sup>32</sup> Information that must be collected includes (1) the number of applications, (2) the purpose and amount of the credit applied for, (3) whether the application was approved, (4) the location of the business, (5) the gross annual revenue of the business, and (6) the race, sex, and ethnicity of the owners of the business as well as any additional data the CFPB deems necessary.<sup>33</sup> The information collected must then be submitted to the CFPB.<sup>34</sup> In addition, the information compiled and maintained must be retained for three years and made available to any member of the public upon request.<sup>35</sup> Such information will also be made available to the public generally each year by the CFPB.<sup>36</sup> Public dissemination of information will enable communities, governmental entities, creditors, and other interested parties to determine whether the needs and opportunities of the community are being met and provide evidence on which to pursue fair lending claims similar to how Home Mortgage Disclosure Act (“HMDA”) data has been used for decades.<sup>37</sup> The CFPB’s new leadership should continue on the path to implementing Section 1071 because a final rule could be crucial to furthering important

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30. *See id.* (“Subject to the requirements of this section, in the case of any application to a financial institution for credit for women-owned, minority-owned, or small business, the financial institution shall— (1) inquire whether the business is a women-owned, minority-owned, or small business . . .”).

31. Dodd-Frank § 1071(c), 15 U.S.C. § 1691c-2(c).

32. Dodd-Frank § 1071(e)(1), 15 U.S.C. § 1691c-2(e)(1).

33. *See* Dodd-Frank § 1071(e)(2), 15 U.S.C. § 1691c-2(e)(2) (requiring that collected information must be itemized to clearly show certain information such as the number of applications, the purpose and amount of the credit applied for, whether the application was approved, the location of the business, the gross annual revenue of the business, and the race, sex, and ethnicity of the owners of the business).

34. Dodd-Frank § 1071(f)(1), 15 U.S.C. § 1691c-2(f)(1).

35. Dodd-Frank § 1071(f)(2), 15 U.S.C. § 1691c-2(f)(2).

36. *Id.*

37. Dodd-Frank § 1071(a), 15 U.S.C. § 1691c-2(a).

policy goals.<sup>38</sup> However, to be successful in achieving those goals, the implementation must not be overbroad and self-defeating.<sup>39</sup>

*C. Issues to be Addressed in the Rulemaking Process*

Section 1071 leaves open several issues to be addressed by CFPB regulations.<sup>40</sup> The CFPB will prescribe rules and issue guidance for carrying out and enforcing the statutory requirements of Section 1071 through the rulemaking process.<sup>41</sup> Under Section 1071, the CFPB is to issue regulations as to the manner in which financial institutions shall compile and maintain a record of the information received from loan applicants.<sup>42</sup> The CFPB is also responsible for determining whether there is any additional information that would be helpful in fulfilling the purposes of Section 1071, implementing regulations requiring such information to be collected, and issuing guidance to facilitate compliance with the rule.<sup>43</sup> Perhaps the most significant issue to be addressed in the rulemaking process is whether the CFPB will exercise its authority to allow exceptions to or exemptions from Section 1071.<sup>44</sup> Congress has given the CFPB the authority to adopt exceptions to any requirement and may exempt any financial institution or class of financial institutions from the requirements if it deems such exemptions necessary or appropriate.<sup>45</sup>

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38. See Dodd-Frank § 1071, 15 U.S.C. § 1691c-2 (explaining that the goals of Section 1071 are “to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses” and that it seeks to accomplish these goals by requiring financial institutions to compile and maintain records of information provided by loan applicants regarding their status as a women-owned, minority-owned, or small business).

39. See *infra* Part IV (explaining how an overbroad implementation of Section 1071 could be self-defeating).

40. See Dodd-Frank § 1071(g)(1), 15 U.S.C. § 1691c-2(g)(1) (“The Bureau shall prescribe such rules and issue such guidance as may be necessary to carry out, enforce, and compile data pursuant to this section.”); See *infra* Part V (discussing why the CFPB should use its exemption authority to exempt certain community banks from the requirements of Section 1071).

41. See Dodd-Frank § 1071(g)(1), 15 U.S.C. § 1691c-2(g)(1) (“The Bureau shall prescribe such rules and issue such guidance as may be necessary to carry out, enforce, and compile data pursuant to this section.”).

42. Dodd-Frank § 1071(e)(1), 15 U.S.C. § 1691c-2(e)(1).

43. Dodd-Frank § 1071(e)(2)(H), 15 U.S.C. § 1691c-2(e)(2)(H), (g)(3).

44. Dodd-Frank § 1071(g)(2), 15 U.S.C. § 1691c-2(g)(2).

45. *Id.*

The RFI also raises several issues that the CFPB seeks to address in its rulemaking process.<sup>46</sup> Perhaps the most important issue to be addressed, and the primary focus of this Note, is the rule's imposition of additional compliance costs on an already highly-regulated industry,<sup>47</sup> and whether the CFPB will use its exemption or exception authorities to lighten the burdens imposed by the rule.<sup>48</sup> Through the RFI process, the CFPB is seeking information about the potential costs and complexity of imposing these small business data collections and reporting requirements.<sup>49</sup> Some in the industry have expressed concern in response to the RFI that Section 1071 may become an onerous compliance burden that could stifle cost-cutting and other initiatives that have helped small businesses access capital.<sup>50</sup>

The CFPB must also determine the appropriate definition of "small business" for which to apply the requirements of Section 1071.<sup>51</sup> Section 1071 defines "small businesses" as having "the same meaning as 'small business concern' in Section 632" of the Small Business Act,<sup>52</sup> which authorizes the Small Business Administration ("SBA") to set size standards for the definition.<sup>53</sup> Using the North American Industry Classification System ("NAICS"), the SBA defines revenue-based or

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46. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. 22318, 22319 (May 10, 2017) (explaining that the CFPB is seeking answers to five main questions through the RFI process, regarding the definition of "small business," which data points should be compiled, which financial institutions are engaged in business lending, access to credit and financial products offered to businesses, and privacy concerns).

47. See *infra* Part IV.

48. See *infra* Part V.

49. Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22318.

50. See Bater, *Inquiry, supra* note 9 ("Talbot told Bloomberg BNA the ETA is concerned that the effort to collect data 'could morph into onerous, premature restrictions that unnecessarily stifle cost-cutting and time saving innovations that have helped small businesses access capital.');" see also Comment letter from Lilly Thomas, Senior Vice President, Indep. Cmty. Bankers of America, to Monica Jackson, Office of the Exec. Sec'y, Consumer Fin. Prot. Bureau (Sept. 14, 2017), <https://www.regulations.gov/document?D=CFPB-2017-0011-0547> (urging the CFPB to provide relief from the potential compliance costs of Section 1071 in the form of an exemption for community banks).

51. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22319 (explaining that the CFPB is seeking input regarding the appropriate definition of "small business").

52. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 1071(h)(2), 15 U.S.C. § 1691c-2(h)(2) (2016).

53. Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22319.

employee-based size standards for each industry.<sup>54</sup> For its employee-based size standard, businesses in most industries with fewer than 500 employees are considered small businesses, with other industries having different thresholds.<sup>55</sup> For its revenue-based size standard, the cutoff for small businesses is typically around \$7.5 million in average annual receipts, with that number varying based on industry.<sup>56</sup> Through the rulemaking process, however, the CFPB is exploring alternative definitions of “small business” tailored to the needs and goals of Section 1071.<sup>57</sup>

Another important issue to be addressed by the CFPB is how the information collected pursuant to Section 1071 will be used.<sup>58</sup> Considering the stated purpose of Section 1071—“to facilitate enforcement of fair lending laws”<sup>59</sup>—some financial institutions believe the Bureau may use the data collected to pursue fair lending enforcement cases.<sup>60</sup> The other stated purpose—to “enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses”—suggests that the data may primarily be for the use of other entities to diagnose problems and assess opportunities in the market.<sup>61</sup> Experts have noted that the main benefit of collecting this data would be to fill a gap where there is a lack of information about access to credit for small businesses, and women-owned and minority-owned businesses in particular.<sup>62</sup>

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54. 13 C.F.R. § 21.201 (2017); U.S. SMALL BUS. ADMIN., TABLE OF SMALL BUSINESS SIZE STANDARDS 1 (2004), [https://www.sba.gov/sites/default/files/files/Size\\_Standards\\_Table.pdf](https://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf); see CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 5–6 (explaining the SBA’s system for small business classification).

55. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 6.

56. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 9.

57. Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22319.

58. See Victoria Finkle, *CFPB Turns Attention to Small Business Lending Market*, [2016] Banking Daily (BNA) No. 119 (Jun. 21, 2016) (“For traditional banks and online lenders, questions remain about what regulators intend to do with the information they ultimately gather.”).

59. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071(a), 15 U.S.C. § 1691c-2(a) (2016).

60. See Finkle, *supra* note 58 (“Financial institutions are already bracing for the possibility of fair lending enforcement cases, and some worry that the agency could explore additional ways to oversee business lending activities.”).

61. Dodd-Frank § 1071(a), 15 U.S.C. § 1691c-2(a).

62. Finkle, *supra* note 58.

III. THE SMALL BUSINESSES LENDING MARKET AND ITS IMPORTANCE  
TO THE ECONOMY

Small businesses play a key role in community development and economic growth in their local economies and, in the aggregate, affect the national economy.<sup>63</sup> Women-owned and minority-owned businesses are a significant component of the small business world, with 97.7% of all minority-owned businesses and 98.3% of all minority-owned businesses falling under the SBA revenue-based size standard definition of “small business.”<sup>64</sup> They are critical to an innovative and dynamic economy.<sup>65</sup> Firms with fewer than 500 employees have created two out of every three jobs since 1993 and provide work for almost half of all employees.<sup>66</sup> Studies indicate that businesses with fewer than ten employees that had access to credit were three times more likely to create jobs than those with ten or more employees.<sup>67</sup> Areas with high percentages of their workforce employed by small businesses show positive trends in local incomes, employment rates, and poverty rates.<sup>68</sup> When small businesses are in decline, local economies struggle, local government revenue declines, and unemployment rises.<sup>69</sup> These declines are more likely to occur in environments where small businesses have difficulty accessing credit.<sup>70</sup>

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63. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (“Small businesses play a key role in fostering community development and fueling economic growth both nationally and in their local communities.”).

64. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 9.

65. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 10 (“Small businesses are critical to an innovative and dynamic economy, no matter how they are defined.”).

66. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 10–11 (“Small businesses, when defined as having fewer than 500 employees, provide work for almost half of all employees in the private sector. Estimates suggest these businesses have created two out of every three jobs since 1993.”).

67. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 17.

68. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 11.

69. See Fairbrothers & Gorla, *supra* note 1 (“When small to mid-sized businesses shut down, the losses to the economy, especially the local economy, can be lasting and profound . . . [e]mployees may experience prolonged unemployment and costly relocation, and local economies and local government revenues can be severely affected.”).

70. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (“To contribute meaningfully to the U.S. economy, small businesses – and especially women-owned and minority-owned small businesses – need access to credit to smooth business cash flows from current operations and to allow entrepreneurs to take advantage of opportunities for growth.”).

The small business lending market is comprised of a few main types of financial institutions offering various financial products.<sup>71</sup> The vast majority of loans to small businesses originate from traditional financial institutions, including community banks, and to a lesser extent, credit unions and alternative lenders.<sup>72</sup> Community banks have long been the most reliable provider of credit for small businesses even in times of banking crises.<sup>73</sup> The most common financial products offered to small businesses are lines of credit, term loans, and business credit cards in addition to other forms such as trade credit provided by retailers or wholesalers, factoring, and advances for future receipts.<sup>74</sup>

Many small businesses have faced difficulty obtaining credit since the financial crisis.<sup>75</sup> Access to credit is vital for small businesses not only to grow, but also to ensure smooth cash flow for current operations.<sup>76</sup> A SBA study shows a strong correlation between small businesses' ability to access credit and their ability to hire, finding that the inability to secure financing may have led to 16% of small businesses to reduce their number of employees and 10% to reduce employee benefits.<sup>77</sup> According to the same study, another 10% of small businesses were unable to increase store inventory to meet existing demand due to their inability to access credit.<sup>78</sup>

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71. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 25–26 (explaining that the small business lending market is mostly made up of traditional financial institutions, credit unions, and alternative lenders).

72. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 25–26 (explaining that 11% of employer firms and 13% of non-employer firms sought credit from credit unions, with 46% of employer firms and 33% of non-employer firms being approved, and that 21% of employer firms and 28% of non-employer firms sought credit from alternative lenders, with 62% and 45% being approved, respectively).

73. See Wilmarth, Jr., *supra* note 4, at 292 (2015) (“In keeping with their business strategy of building strong relationships, community banks proved to be more reliable sources of credit for small businesses during the last two banking crises, compared with larger banks.”).

74. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 19–20.

75. *Testimony of Dan Sokolov Before the Subcomm. on Investigations, Oversight, and Regs. of the H. Comm. on Small Bus.*, 112th Cong. (2011).

76. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 17 (“Access to financing is vitally important in allowing businesses to grow. For small businesses financing not only provides resources to smooth business cash flows for current operations, but also affords business owners the opportunity to invest in business growth.”).

77. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 17.

78. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 17.

IV. THE IMPACT OF AN OVERBROAD IMPLEMENTATION OF SECTION  
1071

A. *The Importance of Community Banks to the Economy and Small  
Businesses in Particular*

Community banks play a crucial role in their local economies, especially for small businesses in the community.<sup>79</sup> Small businesses' unique financing needs often can only be met by community banks, which employ methods<sup>80</sup> that take soft information—information that is not generally available and is difficult to quantify—into consideration.<sup>81</sup> In contrast, larger financial institutions use traditional banking models that are based exclusively on hard data, which limits their ability to meet small business financing needs.<sup>82</sup> Community banks' vitality to small business lending markets<sup>83</sup> enables these small businesses to contribute to community development and local economic growth.<sup>84</sup> In addition to small businesses, community banks also play a crucial role in providing credit for local commercial real estate and agriculture interests.<sup>85</sup> Community banks are particularly important in rural areas, where, in some instances, they are the only banking office in the county, and without which more than one-third of U.S. counties would have very limited access to banking services.<sup>86</sup> Community banks are able to meet

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79. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (“Small businesses play a key role in fostering community development and fueling economic growth both nationally and in their local communities.”).

80. See Wilmarth, Jr., *supra* note 4, at 289 (“Community banks pursue a “relationship lending” strategy that gives them significant advantages in providing credit to small firms.”).

81. See Tanya D. Marsh, *Reforming the Regulation of Community Banks after Dodd-Frank*, 90 IND. L.J. 179, 193 (2015) (explaining that the relationship-banking model builds on longstanding customer relationships that give the banks richer access to “soft information” about their customers).

82. See *id.* at 193 (explaining that in transactional banking hard information drives performance and quantitative information like credit scores are used to make underwriting decisions).

83. See Wilmarth, Jr., *supra* note 4, at 289 (stating that the community banking sector has consistently served as a dedicated and essential source of credit to small firms).

84. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (“Small businesses play a key role in fostering community development and fueling economic growth both nationally and in their local communities.”).

85. See Marsh, *supra* note 81, at 197 (“Community banks are absolutely vital to the economic health of rural America and to the agricultural economy.”).

86. See Wilmarth, *supra* note 4, at 290 (“[M]ore than one-third of U.S. counties, with a total population of over 16 million people, ‘would have very limited physical access to mainstream banking services without the presence of community banks.’”) (quoting

their clients' needs in a more flexible manner<sup>87</sup> and provide credit to some borrowers who could not obtain financing from other sources.<sup>88</sup>

The most important provider of financing for small businesses has historically been the banking industry, within which community banks have "consistently served as a dedicated and essential source of credit to small firms."<sup>89</sup> Currently, community banks provide about half of all bank credit extended to small businesses, despite the fact that community banks hold less than one-fifth of all banking industry assets.<sup>90</sup> Community banks target small businesses as their primary customers, in contrast to large banks, which seek out mid-sized and large companies.<sup>91</sup>

Community banks are often the best source of financing for small businesses.<sup>92</sup> The 2015 and 2016 Federal Reserve Small Business Credit Surveys found that 46% of surveyed small businesses that applied for credit did so at community banks.<sup>93</sup> According to the Pepperdine Private Capital Index, a 2016 survey of 1,888 small businesses, 22% of businesses with revenues of less than \$5 million that sought credit listed community banks as their primary source of credit.<sup>94</sup> The Federal

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Benjamin R. Backup, *Community Bank Developments in 2012*, 7 FDIC Q., No. 4 at 34 (2013), <https://www.fdic.gov/bank/analytical/quarterly/2013-vol7-4/fdic-quarterly-vol7no4.pdf>.

87. See Hester Pierce et al., Ian Robinson & Thomas Stratmann, *How are Small Banks Faring Under Dodd-Frank?* 14 (George Mason Univ., Working Paper No. 14-05, 2014), <https://www.mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank> (explaining that community bankers believe that the relationship-banking model of banking is inconsistent with Dodd-Frank, because the law favors the standardized lending criteria often employed by larger banks and contains regulations that encourage or insist on standardization of bank products and services).

88. See Tim Critchfield et al., *Community Banks: Their Recent Past, Current Performance, and Future Prospects*, 16 FDIC BANKING REV. 1, 4 (2004), <https://www.fdic.gov/bank/analytical/banking/2005jan/br16n34full.pdf> (explaining that community banks are often able to successfully lend to informationally opaque borrowers that have trouble obtaining credit from large banks because they do not have long credit histories suitable for credit-scoring or other model-based lending practiced by large banks).

89. Wilmarth, Jr., *supra* note 4, at 288; See also CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 24 (stating that small businesses continue to rely on traditional financial institutions, defined as large banks and small banks, as their primary source of financing).

90. JEFFREY W. GUNTHER & KELLY KLEMME, FED. RESERVE BANK OF DALL., 2012 ANNUAL REPORT: A LENDER FOR TOUGH TIMES (2012) <http://www.dallasfed.org/microsites/fed/annual/2012/documents/ar12.pdf> (finding that banks with under \$10 billion "held 17 percent of industrywide banking assets as of June 2012—but they accounted for more than half of the amount lent to small businesses.").

91. Wilmarth, Jr., *supra* note 4, at 291.

92. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 24 (explaining that small businesses are more likely to be able to obtain financing from community banks than large banks).

93. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 24.

94. CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 25.

Reserve Survey also found that employer small businesses—those with at least one employee—and non-employer small businesses—those with no employees—that applied for credit were 13% and 20% more likely to be approved for financing from a small bank than from a large bank, respectively.<sup>95</sup> These findings highlight a key advantage community banks provide to small businesses—they will often provide credit to small businesses that cannot obtain credit from large banks or other intermediaries.<sup>96</sup>

Community banks can also be the most reliable source of credit for small businesses.<sup>97</sup> During the financial crisis, larger banks drastically decreased their lending to small businesses, whereas community banks increased their share of the small business lending market, despite their declining share of total banking industry assets in the same time period.<sup>98</sup> Community banks also outpaced large banks in small business lending growth during the recovery.<sup>99</sup>

The advantages provided by community banks in small-business lending are primarily due to their use of “relationship banking,” rather than the transactional banking strategy employed by large banks.<sup>100</sup> By engaging in a “relationship banking” strategy, community banks are able to meet their clients’ needs in a more flexible manner and provide credit to some borrowers who could not obtain financing from other sources.<sup>101</sup> Transactional banking involves highly standardized products and relies

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95. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 25 (“Of those that applied, 67 percent of employer small businesses and 52 percent of non-employer businesses were approved for financing from a small bank, while larger banks only approved 54 percent of employer small businesses and 32 percent of non-employer small businesses that applied for credit.”).

96. See CONSUMER FIN. PROT. BUREAU, *supra* note 2 (finding that small businesses were more likely to be approved for financing by a small bank than a large bank).

97. See Wilmarth, Jr., *supra* note 4, at 292 (“In keeping with their business strategy of building strong relationships, community banks proved to be more reliable sources of credit for small businesses during the last two banking crises, compared with larger banks.”).

98. See Wilmarth, Jr., *supra* note 4, at 292 (explaining that during the most recent crisis, larger banks cut back sharply on their small business lending, while community banks slightly increased their share of the small business lending market between mid-2008 and mid-2012, even though their share of total banking industry assets declined during that period).

99. See Wilmarth, Jr., *supra* note 4, at 293 (“Moreover, small business lending grew at a significantly faster rate at community banks during 2013 and 2014, compared with the rest of the banking industry.”).

100. See Wilmarth, Jr., *supra* note 4, at 289 (“Community banks pursue a “relationship lending” strategy that gives them significant advantages in providing credit to small firms.”).

101. See CONSUMER FIN. PROT. BUREAU, *supra* note 2 (finding that small businesses were more likely to be approved for financing by a small bank than a large bank).

on “hard data” such as credit scores to make underwriting decisions.<sup>102</sup> Relationship banking, on the other hand, depends on longstanding relationships with customers that give banks richer access to “soft information” about their customers that cannot be easily quantified.<sup>103</sup> Community banks utilize this soft information to afford their employees more discretion in making lending decisions<sup>104</sup> in ways that better serve many borrowers than with a purely quantitative strategy.<sup>105</sup>

Community banks can offer more personalized services to their customers due to their longstanding business and personal relationships.<sup>106</sup> Community bank managers generally have long tenures and are often deeply involved in their communities, so they have superior ability to assess and monitor local firms.<sup>107</sup> Relationship banking can be very beneficial to small businesses, because many such firms are “informationally opaque,” meaning they do not have long credit histories suitable for credit scoring or other model-based lending practiced by large banks, and community banks can overcome this challenge by utilizing soft information.<sup>108</sup> Utilization of relationship banking strategies awards community banks with a degree of flexibility not available to large banks, which rely on highly-standardized transactional banking strategies.<sup>109</sup>

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102. See Marsh, *supra* note 81, at 193 (explaining that “in transactional banking hard information drives performance” and quantitative information like credit scores are used to make underwriting decisions).

103. See Marsh, *supra* note 81, at 193 (explaining that the relationship-banking model builds on longstanding customer relationships that give the banks richer access to “soft information” about their customers).

104. See Marsh, *supra* note 81, at 193 (“Computer models may be used to enhance underwriting, but more authority is given to community bank employees to make lending decisions.”).

105. See Marsh, *supra* note 81, at 193 (“[S]tudies have shown that many borrowers, particularly small businesses, farmers, and individuals, are better served by relationship banking than by the transactional-banking model.”).

106. Adam R. Lewis, Note, *North Carolina Community Banks: Survival Strategies for Turbulent Times*, 17 N.C. BANKING INST. 333, 353 (2013) (“Community banks know their customers well and are able to offer more personalized service and advice.”).

107. See Wilmarth, Jr., *supra* note 4, at 289 (“Community banks have a superior ability to assess and monitor local firms because their managers and loan officers generally have long tenures in their positions and are deeply involved in the life of their communities.”).

108. See Critchfield et al., *supra* note 88, at 4 (explaining that the strength of community banks stems from their ability to successfully lend to “informationally opaque” borrowers that have trouble obtaining credit from large banks because they do not have “long credit histories suitable for credit-scoring or other model-based lending practiced by large banks . . .”).

109. See Wilmarth, Jr., *supra* note 4, at 347 (“[B]ig banks provide credit to small businesses primarily through standardized, ‘cookie cutter’ loan programs, including business

Unfortunately, community bankers feel that certain parts of Dodd-Frank, including Section 1071, threaten the relationship banking model, thus harming borrowers like small businesses that depend on relationship banking.<sup>110</sup>

*B. Compliance Costs and Competitive Environment*

The compliance costs associated with Section 1071 could prove to be too burdensome for community banks and force them to exit the market by limiting their access to credit, which would be very harmful to women-owned, minority-owned, and small businesses that the rule was enacted to protect.<sup>111</sup> About half of small businesses turn to community banks to apply for credit, where they were 13% to 20% more likely to be approved, and 22% of these small businesses depend on community banks as their primary source of credit.<sup>112</sup> Also, these small businesses would be left without access to the same quality of banking that community banks have historically provided through the process of relationship banking,<sup>113</sup> and in some cases would be left without access to credit at all.<sup>114</sup> Even for community banks that would not fail, they may not be able to practice relationship banking to the same level as before due to the standardized nature of Section 1071's requirements.<sup>115</sup>

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credit cards and equipment leases, which (1) rely on impersonal credit-scoring techniques and other automated technologies and (2) enable many of the resulting loans to be securitized.”).

110. See Pierce et al., *supra* note 87, at 14 (explaining that community bankers believe that the relationship-banking model of banking is inconsistent with Dodd-Frank).

111. See Lewis, *supra* note 106, at 345 (explaining that community banks face compliance cost threats and a great number of banks with between \$100 million and \$250 million in assets have failed in recent years).

112. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 25 (“Of those that applied, 67 percent of employer small businesses and 52 percent of non-employer businesses were approved for financing from a small bank, while larger banks only approved 54 percent of employer small businesses and 32 percent of non-employer small businesses that applied for credit. According to the Pepperdine Index, a comparable small bank statistic suggests about 22 percent of surveyed businesses with revenues less than \$5 million that sought credit listed community banks as their primary source of credit.”).

113. See Marsh, *supra* note 81, at 193 (“[S]tudies have shown that many borrowers, particularly small businesses, farmers, and individuals, are better served by relationship banking than by the transactional-banking model.”).

114. See Critchfield et al., *supra* note 88, at 4 (explaining that community banks have unique abilities to successfully lend to borrowers that have trouble obtaining credit from large banks).

115. See Pierce et al., *supra* note 87, at 14 (explaining that community bankers believe that the relationship-banking model of banking is inconsistent with Dodd-Frank, because the

In order to understand the impact of legislation like Section 1071 on community banks, it is necessary to understand the current economic environment in which they operate. Two important factors in the community bank market are competitive pressures presented by large banks and compliance costs presented by recent legislation and regulation.<sup>116</sup> These competitive pressures and burdensome compliance costs are contributing factors to the trend of many community banks failing, merging together to reduce costs and achieve a certain scale, or being acquired by larger financial institutions.<sup>117</sup> This trend is shrinking the market and leading some in the industry to predict that community banks will eventually disappear entirely.<sup>118</sup>

Competitive pressure in the lending marketplace disrupts the economic viability of community banks.<sup>119</sup> Various statutes passed in the 1990s<sup>120</sup> deregulated the banking industry and contributed to a trend of consolidation.<sup>121</sup> This resulted in a large concentration of power and assets in a few big banks, which created significant competitive problems for community banks.<sup>122</sup> Today, the six largest bank holding companies in America hold 67% of all bank holding company assets.<sup>123</sup> As the

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law favors the standardized lending criteria often employed by larger banks and contains regulations that encourage or insist on standardization of bank products and services).

116. See Marsh, *supra* note 81, at 225 (discussing the competitive disadvantages faced by community banks and how they will be further exacerbated by new compliance costs).

117. See Lewis, *supra* note 106, at 346–51 (discussing recent community bank failures, acquisitions, and mergers).

118. See Anthony Gaeta, Jr., *The Future of Community Banking*, 20 N.C. BANKING INST. 1, 1 (2016) (“In my conclusion, I stated that ‘so alas, I see the demise and eventual extinguishment of true small town community banks.’”).

119. See Marsh, *supra* note 81, at 225 (discussing the competitive disadvantages faced by community banks and how they will be further exacerbated by new compliance costs).

120. See Lewis, *supra* note 106, at 336–37 (explaining that Riegle-Neal, by lifting the Bank Holding Company Act’s prohibition on interstate banking, allowed large banks to establish branches in other states, significantly increasing the number of potential competitors for community banks; then further explaining how community banks’ competitive problems were exacerbated by the passage of the Gramm-Leach-Bliley Act, which repealed Glass-Steagall and allowed bank holding companies to grow larger through acquisition of companies engaged in financial in nature activities, further increasing competition to community banks and endangering them).

121. See Lewis, *supra* note 106 at 336–37 (describing how Congress passed a number of laws in the 1990s that deregulated the banking industry and opened the door for large financial institutions to grow even larger and to compete directly with community banks).

122. See Brynne Krause, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: How Increased Regulation Has Given Large Banks an Artificial Competitive Edge*, 83 UMKC L. REV. 1045, 1048 (2015) (stating that the six largest banks in America hold 67% of all banking industry assets).

123. *Id.*

biggest financial institutions merge to become even larger, they are able to absorb new costs such as compliance costs more easily than smaller banks, making it harder for community banks to compete.<sup>124</sup> During the 2008 financial crisis, many of these larger banks received government assistance, while some smaller banks were allowed to fail.<sup>125</sup> This created a perception that large banks are safer because of government backing in times of crisis, causing consumers to flee the smaller banks that may not receive such assistance.<sup>126</sup>

In addition to competitive pressures, community banks have faced growing compliance costs over the past two decades that some banks have found to be too much of a burden to continue operating.<sup>127</sup> After already struggling to comply with previous enactments,<sup>128</sup> community banks were hit with the largest imposition of compliance costs that they had ever faced in the form of Dodd-Frank.<sup>129</sup> Critics agree that these new significant compliance costs place community banks at a further competitive disadvantage.<sup>130</sup> A George Mason University survey found that community banks that responded have had increased compliance costs since Dodd-Frank was passed, with many respondents reporting that they would have to hire one to two additional employees to meet the statutory requirements.<sup>131</sup> In response to a survey conducted by the Federal Reserve Bank of Kansas, 84% of community banks reported

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124. See Lewis, *supra* note 106, at 342 (explaining that larger banking entities may have a compliance department or in-house counsel in addition to at least one law firm on retainer, enabling them to better adapt to compliance costs, but community banks usually lack such resources).

125. Lewis, *supra* note 106, at 342.

126. Lewis, *supra* note 106, at 342.

127. See Lewis, *supra* note 106, at 345 (explaining that community banks face compliance cost threats and a great number of banks with between \$100 million and \$250 million in assets have failed in recent years).

128. The Sarbanes-Oxley Act of 2002 (“SOX”) was the first major compliance hurdle faced by community banks in recent years, passed in response to the failure of Enron and related scandals in the early 2000s, SOX imposed new reporting requirements that placed a tremendous and disproportionate burden on publicly held community banks, decreasing profitability and their ability to compete. *Sarbanes-Oxley Essential Information*, SOX-ONLINE, <http://www.sox-online.com/sarbanes-oxley-basics/> (last visited Feb. 4, 2018); Lewis, *supra* note 106, at 337–38.

129. See Regina F. Burch, *Financial Regulatory Reform Post-Financial Crisis: Unintended Consequences for Small Businesses*, 115 PENN. ST. L. REV. 409, 413 (2012) (stating that Dodd-Frank is “the most sweeping financial industry reform legislation since the Great Depression”).

130. Marsh, *supra* note 81, at 226.

131. Pierce et al., *supra* note 87, at 34.

that compliance requirements were the most significant challenge they faced.<sup>132</sup> Whereas larger banks tend to have compliance departments or in-house counsel to work on these compliance requirements, community banks usually lack such resources, increasing the difficulty of adapting to new regulations.<sup>133</sup> “Outsourcing much of this regulatory burden is expensive and self-staffing by the community banks is even more impractical from an expense standpoint.”<sup>134</sup>

The competitive pressures and compliance costs currently faced by community banks have led to a trend of consolidation and bank failures.<sup>135</sup> According to the same George Mason University study, the number of community banks has shrunk 14% since Dodd-Frank was passed, and 27% since 2000.<sup>136</sup> Since 2008, 555 banks have failed, a great number of which were banks with between \$100 million and \$250 million in assets.<sup>137</sup> In North Carolina alone, Waccamaw Bank, Blue Ridge Savings Bank, The Bank of Asheville, Cooperative Bank, and Cape Fear Bank have all failed in recent years.<sup>138</sup> Some reports, however, express doubts as to whether Dodd-Frank is the main cause of this consolidation.<sup>139</sup>

In the face of potential failure, community banks have a few options.<sup>140</sup> Specifically, they can merge with other community banks or seek to be acquired by another institution.<sup>141</sup> Currently, bank holding

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132. FED. RESERVE BANK OF KAN. CITY DIV. OF SUPERVISION AND RISK MGMT., SURVEY OF COMMUNITY DEPOSITORY INSTITUTIONS 1, 4 (August 2011), <https://www.kansascityfed.org/publicat/banking/surveycommbanks/11BankResults.pdf>.

133. Lewis, *supra* note 106, at 342.

134. Gaeta, Jr., *supra* note 118, at 4.

135. Marsh, *supra* note 81, at 185.

136. Hester Pierce & Stephen Matteo Miller, *Small Banks By the Numbers, 2000-2014*, MERCATUS CENTER (Mar. 17, 2015), <https://www.mercatus.org/publication/small-banks-numbers-2000-2014>.

137. FED. DEPOSIT INS. CORP., FAILED BANK LIST, <http://fdic.gov/bank/individual/failed/banklist.html> (last visited Feb. 3, 2018) (covering bank failures between Jan. 1, 2000 and Jan. 3, 2018).

138. *List of Failed Banks 2009–2017*, BANKRATE (Jan. 10, 2017), <http://www.bankrate.com/finance/banking/failed-banks-north-carolina.aspx>.

139. Deena Zaidi, *Is Dodd-Frank Really Killing Community Banks?*, THE STREET (Nov. 3, 2015, 12:17 PM), <https://www.thestreet.com/story/13348453/1-is-dodd-frank-really-killing-community-banks.html>; See COUNCIL OF ECON. ADVISERS, THE WHITE HOUSE, THE PERFORMANCE OF COMMUNITY BANKS OVER TIME 1, 3 (2016), available at [https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160810\\_cea\\_community\\_banks.pdf](https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160810_cea_community_banks.pdf) (Aug. 2016) (explaining that bank consolidation is a long-running trend that has been occurring since long before the passage of Dodd-Frank).

140. Lewis, *supra* note 106, at 346–49.

141. Lewis, *supra* note 106, at 346–49.

companies are reluctant to acquire community banks in a market that is saturated with banks with assets in the billions.<sup>142</sup> The recent success of community bank mergers suggests that merging may be the best option for struggling community banks.<sup>143</sup> The bottom line is that the bigger the entity, the more likely it is that it can absorb increased compliance costs.<sup>144</sup> The data from 2011 shows that banks with under \$250 million in assets failed at three times the rate of those over that threshold.<sup>145</sup> It seems clear that in the current environment, struggling community banks either merge or are acquired, while some fail, all of which decrease the number of community banks in the market, disproportionately affecting small businesses.<sup>146</sup>

C. *The Impact of Community Banks Exiting the Small Business Lending Market*

The number of community banks has decreased over recent years due to competitive pressures and compliance costs, and will continue to do so as more compliance costs are imposed on these already-struggling institutions.<sup>147</sup> A 2013 Federal Reserve Bank of Minneapolis study projected that nearly “[13%] of the banks with assets less than \$50 million would become unprofitable” when the staff is increased by one half of a person.<sup>148</sup> Such staff increases have come to fruition according to the George Mason University study, which found that the median compliance staff of the banks surveyed have already had to hire an additional employee because of Dodd-Frank.<sup>149</sup> Thus, it would not be surprising if these banks had to hire more employees as the remainder of Dodd-

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142. Lewis, *supra* note 106, at 346.

143. Lewis, *supra* note 106, at 334.

144. See Lewis, *supra* note 106, at 342 (explaining that, whereas larger banks tend to have compliance departments or in-house counsel to combat compliance costs, community banks usually lack such resources, making it more difficult to adapt to new regulations).

145. *Bank Failures in Brief*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/historical/bank/2011/index.html> (last visited Feb. 10, 2018).

146. Lewis, *supra* note 106, at 346–49.

147. Lewis, *supra* note 106, at 346–49.

148. FED. RESERVE BANK OF MINNEAPOLIS, QUANTIFYING THE COSTS OF ADDITIONAL REGULATION ON COMMUNITY BANKS 1, 6 (2013).

149. See Pierce et al., *supra* note 87 (“The median number of compliance staff for the banks in our survey increased from one to two, and more than a quarter of respondents plan to add another compliance person.”).

Frank—including Section 1071—is implemented, possibly making them unprofitable.<sup>150</sup>

The recent community bank failures have inflicted serious harm on small businesses and communities.<sup>151</sup> Prominent economists have observed that the community bank failures have had a disproportionate impact on small businesses.<sup>152</sup> Similar bank failures “between 2008 and 2010 had significant adverse impacts on income, employment, compensation growth, and poverty in the counties where the failures occurred.”<sup>153</sup> Through relationship banking, community banks are able to provide credit to some small businesses that cannot obtain affordable credit elsewhere.<sup>154</sup> This was apparent in some areas where “many small businesses could not find any type of external funding—or were forced to rely on much more expensive credit from nonbank lenders” because local community banks failed or were unable to continue providing loans to their established small firm customers.<sup>155</sup>

A further decline in community banks would threaten small businesses, consumers, and local communities.<sup>156</sup> There is a well-established link between small businesses and community banks, explaining why small firms, consumers, and local communities suffer when community banks do not have a competitive presence in local markets.<sup>157</sup> The main impact of community bank failures on communities will be the decreased availability of funding for small businesses.<sup>158</sup> Thus, the declining role of community banks as providers of credit, which reflects the consolidation of the banking system, is probably a significant factor in the downtrend in the share of credit provided to small

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150. See Pierce et al., *supra* note 87, at 35 (showing that compliance burdens of Dodd-Frank force small banks to hire additional employees).

151. Wilmarth, Jr., *supra* note 4, at 294.

152. See Wilmarth, Jr., *supra* note 4, at 294 (statement of Mark Gentler) (“The demise of local lenders has inflicted a disproportionate blow on small enterprises.”) (statement of Mark Zandi) (“Small bank failures matter a lot to the communities in which they operate, especially in non-urban areas. Small banks are key to small businesses.”).

153. Wilmarth, Jr., *supra* note 4, at 294.

154. See Critchfield et al., *supra* note 88, at 4 (explaining that the strength of community banks stems from their ability to utilize a relationship banking model to successfully lend to “informationally opaque” borrowers).

155. Wilmarth, Jr., *supra* note 4, at 295.

156. Wilmarth, Jr., *supra* note 4, at 298.

157. Wilmarth, Jr., *supra* note 4, at 298.

158. Lewis, *supra* note 106, at 354.

businesses.<sup>159</sup> A recent study found that small businesses “were less likely to obtain credit from banks” and “were likely to receive lower amounts of credit” in markets dominated by the largest banks.<sup>160</sup> These large banks also charge substantially higher fees on deposit account services compared to community banks, which probably contributes to community banks’ much higher rates of customer satisfaction and a higher level of citizen trust.<sup>161</sup> Small businesses suffer when community banks fail, and because small businesses are so vital to their communities, their failures can cause local economies to struggle.<sup>162</sup>

As community banks exit the market, other entities will fill in to meet their customers’ banking needs, but it is doubtful whether they can do so as effectively as community banks.<sup>163</sup> Small businesses would probably have more trouble obtaining financing with these alternative lenders.<sup>164</sup> Credit unions have very conservative lending standards and big banks do not participate in relationship banking, so even if these small businesses are able to obtain credit, it almost certainly would not come with the same level of flexibility as provided by relationship banking.<sup>165</sup> Since relationship banking can sometimes be the only lending technique that affords informationally opaque borrowers the ability to obtain financing,<sup>166</sup> “[m]any of the loans small business owners depend on to start new businesses, or expand existing businesses, will not be available if community banks disappear” because credit unions, big banks, and other alternative sources of credit do not consider such factors.<sup>167</sup>

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159. Wilmarth, Jr., *supra* note 4, at 298.

160. Wilmarth, Jr., *supra* note 4, at 298.

161. Wilmarth, Jr., *supra* note 4, at 299.

162. Fairbrothers & Gorla, *supra* note 1, at X.

163. See Lewis, *supra* note 106, at 353 (“Undoubtedly, other entities will fill in to meet the banking needs of most general customers.”).

164. See Lewis, *supra* note 106, at 353 (“However, it may be more difficult for some borrowers to be approved for credit.”).

165. See Lewis, *supra* note 106, at 353 (“Credit unions, as non-profit and tax-exempt entities, have very conservative lending standards, and big banks are not willing to provide “reputational lending” to the same extent as community banks.”).

166. See Critchfield et al., *supra* note 88, at 4 (explaining that community banks are more able to successfully lend to “informationally opaque” borrowers that have trouble obtaining credit from large banks because they do not have long credit histories suitable for credit-scoring or other model-based lending practiced by large banks).

167. Lewis, *supra* note 106, at 354.

V. EXEMPTING COMMUNITY BANKS WITH LESS THAN \$50 MILLION IN ASSETS

Those in the community banking industry have made a resounding plea to the CFPB to exempt community banks from the implementation of Section 1071.<sup>168</sup> There is precedent for the CFPB exempting smaller financial institutions from reporting requirements.<sup>169</sup> For example, in 2013, the CFPB exempted mortgage servicers that service 5,000 or fewer mortgages from its new Mortgage Servicing Rules.<sup>170</sup> The CFPB has also exempted small banks and credit unions from its payday lending rule.<sup>171</sup> The exemption would also fit within the larger emerging regulatory scheme of tailoring regulations to bank size.<sup>172</sup>

The CFPB should not, however, exempt all community banks, as overbroad exclusions could potentially render Section 1071 ineffective.<sup>173</sup> Since community banks occupy around half of the small business lending market, an outright exclusion would leave data on half

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168. Comment letter from Tom Quadman, Exec. Vice President, Ctr. for Capital Mkts. Competitiveness, to Monica Jackson, Office of the Exec. Sec'y, Consumer Fin. Prot. Bureau (Sept. 14, 2017), <https://www.regulations.gov/document?D=CFPB-2017-0011-0630>; Thomas, *supra* note 50.

169. See CONSUMER FIN. PROT. BUREAU, 2013 REAL ESTATE SETTLEMENT PROCEDURES ACT (REGULATION X) AND TRUTH IN LENDING ACT (REGULATION Z) MORTGAGE SERVICING FINAL RULES 14 (2013), [http://files.consumerfinance.gov/f/201306\\_cfpb\\_compliance-guide\\_2013-mortgage-servicing-rules.pdf](http://files.consumerfinance.gov/f/201306_cfpb_compliance-guide_2013-mortgage-servicing-rules.pdf) [hereinafter CONSUMER FIN. PROT. BUREAU, REGULATION X AND REGULATION Z] (explaining the exemption for small servicers from certain parts of the Mortgage Servicing Rules); see also Jeff Bater, *Small Banks, Credit Unions Win Carve-Out in CFPB Payday Rule*, [2017] Banking Daily (BNA) No. 193 (October 6, 2017) [hereinafter Bater, *Carve-Out*] (explaining that the CFPB's final rule on payday lending will exempt lenders who make 2,500 or fewer short-term or balloon payment loans per year and derive less than 10% of their revenue from such loans).

170. See CONSUMER FIN. PROT. BUREAU, REGULATION X AND REGULATION Z, *supra* note 169, at 14 ("Servicers that qualify as small servicers are exempt from certain parts of the Mortgage Servicing Rules.").

171. See Bater, *Carve-Out*, *supra* note 169 (explaining the CFPB's exemption for lenders who make 2,500 or fewer short-term or balloon payment loans per year and derive less than 10% of their revenue from such loans from its final rule on payday lending).

172. See Jeanna Smialek, *Yellen Says Fed Working on Tailoring Regulations to Bank Size*, [2017] Banking Daily (BNA) No. 192 (October 5, 2017) (explaining that the Federal Reserve Board has been working to ensure that banking regulations are tailored to the size of the financial institution.).

173. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. 22318 (May 10, 2017) ("In order to achieve this statutory purpose, the Bureau believes the section 1071 data should cover an extensive share of the market and contain enough flexibility to analyze different market segments.").

of the loans that Section 1071 inaccessible to the CFPB, limiting the effectiveness of the rule.<sup>174</sup> Without the ability to monitor these loans, the CFPB cannot achieve their stated goal of facilitating enforcement of fair lending laws on this half of small business loans.<sup>175</sup> It is also important to keep in mind that while relationship banking has many great advantages, it also allows a great deal of discretion, which may open the door for bank employees' inherent biases to impact lending decisions—either intentionally or unintentionally.<sup>176</sup> Also, without the data from half of the small business lending market, the CFPB would have an incomplete data set upon which it could attempt to accomplish its stated goal of enabling “communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses.”<sup>177</sup> While it is not necessary to possess data for every small business loan to draw conclusions about the small business lending market, it certainly leads to more accurate decisions if at least some of the data from community bank loans were included.<sup>178</sup> The National Community Reinvestment Coalition (“NCRC”) issued a white paper urging the CFPB to take an expansive approach in developing its final rule, and not to create exemptions that would exclude “significant numbers of financial institutions.”<sup>179</sup> The NCRC fears that overbroad exclusions could “obfuscate or result in market distortions,” impair the ability to engage in

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174. See Wilmarth, Jr., *supra* note 4, at 289 (stating that community banks make up about half of the small business lending market).

175. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071(a), 15 U.S.C. § 1691c-2(a) (2016).

176. See Marsh, *supra* note 81, at 193 (“Computer models may be used to enhance underwriting, but more authority is given to community bank employees to make lending decisions.”).

177. Dodd-Frank § 1071(a), 15 U.S.C. § 1691c-2(a).

178. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. 22318, 22319 (May 10, 2017) (“In order to achieve this statutory purpose, the Bureau believes the section 1071 data should cover an extensive share of the market and contain enough flexibility to analyze different market segments.”).

179. See NAT'L CMTY. REINVESTMENT COAL., SMALL BUSINESS LOAN DATA: RECOMMENDATIONS TO THE CONSUMER FINANCIAL PROTECTION BUREAU FOR IMPLEMENTING SECTION 1071 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 33 (2014), <https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2014/08/recommendations-to-cfpb-on-small-business-loan-data.pdf> (“The ability to engage in fair lending enforcement is impaired if significant numbers of financial institutions are exempted.”).

fair lending enforcement, and constrain the public's ability to determine unmet needs.<sup>180</sup>

The most effective solution is to implement a size-based exclusion for community banks with less than \$50 million in assets—those that need compliance relief most.<sup>181</sup> While most size-based exclusions are somewhat arbitrary, such an exemption is a bright line rule that is easy to implement since the only information needed is the value of the bank's assets, and \$50 million in assets is a logical line to draw because it is the threshold at which banks would start to become unprofitable due to additional compliance costs.<sup>182</sup> This would provide a more efficient process for accomplishing the stated goal of facilitating enforcement of fair lending laws, without imposing too heavy of a compliance burden on those community banks most at risk of being unable to meet the demands of Section 1071.<sup>183</sup> The dataset of information on small business loans would still be incomplete, but the missing portion would not be nearly as vast with only the smallest community banks being excluded.<sup>184</sup> This would enable the public to draw more accurate conclusions about the small business lending market to determine unmet needs.<sup>185</sup> Overall, providing an exemption for community banks with under \$50 million in assets would strike a good balance between limiting onerous compliance costs that could put

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180. *Id.* at 16.

181. See FED. RESERVE BANK OF MINNEAPOLIS, *supra* note 148, at 2 (finding that many banks with less than \$50 million in assets become unprofitable when forced to hire additional employees).

182. See FED. RESERVE BANK OF MINNEAPOLIS, *supra* note 148, at 2 (“By way of example, we find that the median reduction in profitability for banks with less than \$50 million in assets is 14 basis points if they have to increase staff by one half of a person; the reduction is 45 basis points if they increase staffing by two employees. The former increase in staff leads an additional 6 percent of banks this size to become unprofitable, while the latter increase leads an additional 33 percent to become unprofitable.”).

183. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071(a), 15 U.S.C. § 1691c-2(a) (2016).

184. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. at 22319 (explaining the importance of collecting enough data to cover an extensive share of the small business lending market).

185. See NAT'L CMTY. REINVESTMENT COAL., *supra* note 179, at 16 (explaining that overbroad exclusions could “obfuscate or result in market distortions,” impair the ability to engage in fair lending enforcement, and constrain the public's ability to determine unmet needs).

community banks in danger of failure and providing overbroad exclusions that could potentially render the rule ineffective.<sup>186</sup>

A. *An Exemption Would Reduce Significant Compliance Costs Imposed by Section 1071*

Section 1071 imposes vast new compliance costs on community banks and, in some cases, may even lead to their failures.<sup>187</sup> Community banks already face heavy competitive pressures from larger banks, and imposing more heavy compliance costs places them at an even greater competitive disadvantage when the larger banks are more able to adapt to these costs.<sup>188</sup> The need to hire even one additional person to comply with the law could be the death knell to a community bank.<sup>189</sup> While the precise impact of implementing Section 1071 in a broad form is not yet clear, it is not difficult to project that a rule requiring extensive information gathering, recordkeeping, and reporting could force community banks to hire additional employees to comply with these requirements.<sup>190</sup> In the RFI, the CFPB even recognized the potential for Section 1071 to be burdensome to community banks and stated a goal of minimizing its burden to both the industry and the Bureau.<sup>191</sup>

Much of the concern stems from the heterogeneous nature of small business lending, which would be incompatible with collecting

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186. See NAT'L CMTY. REINVESTMENT COAL., *supra* note 179, at 16 (explaining how providing exclusions for too large of a segment of the market could result in market distortions, limiting the usefulness of the information).

187. See Burch, *supra* note 129, at 413 (stating that Dodd-Frank is “the most sweeping financial industry reform legislation since the Great Depression”).

188. See Lewis, *supra* note 106, at 342 (explaining that community banks usually do not have compliance departments similar to those at larger banks, making it more difficult to adapt to new regulations).

189. See FED. RESERVE BANK OF MINNEAPOLIS, *supra* note 148 (finding that “[thirteen] percent of the banks with assets less than \$50 million would become unprofitable” when the staff is increased by one half of a person).

190. See Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071, 15 U.S.C. § 1691c-2 (2016) (describing the expansive information gathering, recordkeeping, and reporting required by the Section 1071).

191. See Request for Information Regarding the Small Business Lending Market, 82 Fed. Reg. 22318 (May 10, 2017) (“The Bureau is interested in exploring potential ways to implement Section 1071 in a balanced manner with a goal of providing timely data with the highest potential for achieving the statutory objectives, while minimizing burden to both industry and the Bureau.”).

mass data.<sup>192</sup> A GAO report conducted prior to the enactment of Section 1071 analyzed the potential costs of the kind of data collection required by Section 1071.<sup>193</sup> The report warned that such data collection and reporting could impose major compliance burdens, with potential costs including information system integration, employee training, and compliance costs.<sup>194</sup>

The costs of complying would likely be similar to those of a similar reporting regime that has been in place for decades under the HMDA.<sup>195</sup> The HMDA requires certain depository institutions to disclose similar data points to those required by Section 1071, including the race, gender, and income level of all mortgage applicants.<sup>196</sup> Also, one purpose of the HMDA—to make the data collected publicly available to be used to identify potentially discriminatory lending patterns and practices<sup>197</sup>—is similar to that of Section 1071.<sup>198</sup> The CFPB, since the passage of the Dodd-Frank Act, also has HMDA rulemaking authority.<sup>199</sup> In October 2015, the CFPB issued a final rule regarding the HMDA, which introduced sweeping changes and imposed additional compliance

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192. See Comment letter from Barry Mills, Senior Regulatory Advisor, Am. Bankers Ass'n, to Monica Jackson, Office of the Exec. Sec'y, Consumer Fin. Prot. Bureau (Sept. 14, 2017), <https://www.regulations.gov/document?D=CFPB-2017-0011-0635> (“Small business lending at banks is highly individualized, and underwriting and loan pricing depend on many heterogeneous variables that are inherently unsuitable for mass-data fair lending analysis.”).

193. See U.S. GOV'T ACCOUNTABILITY OFF., FAIR LENDING: DATA LIMITATIONS AND THE FRAGMENTED U.S. FINANCIAL REGULATORY STRUCTURE CHALLENGE FEDERAL OVERSIGHT AND ENFORCEMENT EFFORTS 27 (July 2009) (analyzing potential costs of data collections in connection to fair lending enforcement).

194. See *id.* (“These potential costs included information system integration, employee training, and compliance costs.”).

195. See Mike Ferullo, *Application Data Not Required from Banks Until Rules Are Written*, *CFPB Counsel Says*, [2011] *Banking Daily (BNA)* No. 70 (May 11, 2017) (“A similar reporting regime has been in place for decades under the Home Mortgage Disclosure Act, which covers residential mortgages and home improvement loans.”).

196. See LISSA L. BROOME & JERRY W. MARKHAM, *REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS* 429 (4th ed. 2012) (explaining that the HMDA requires certain depository institutions to disclose race, gender and income levels of mortgage applicants).

197. *Id.*

198. See Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 1071(a), 15 U.S.C. § 1691c-2(a) (2016). (“The purpose of [Section 1071] is to facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses.”).

199. BROOME & MARKHAM, *supra* note 196, at 429.

burdens.<sup>200</sup> With the CFPB increasing regulatory requirements, many institutions have had to “implement more robust compliance management systems,” with costs potentially impacting their ability to offer quality products and services.<sup>201</sup> Due to the new HMDA requirements, institutions will have to consider new information technology challenges, compliance personnel appointments or engage third-party vendors, and additional privacy risks.<sup>202</sup>

As costly as HMDA compliance has been for financial institutions, Section 1071 would likely be even more burdensome due to key differences in mortgage-lending and small business lending practices.<sup>203</sup> Whereas mortgage lending can be a formulaic process, small business lending typically relies on more complicated standards.<sup>204</sup> For small business lending, there is usually no standardized application process, as each small business has unique credit needs tailored to its own distinctive characteristics.<sup>205</sup> Thus, current practices in the small business lending market would not conform to standard data collection efforts.<sup>206</sup>

This is especially true for community banks, which, as the Independent Community Bankers of America (“ICBA”) highlights in its response to the RFI, could face a disproportionate burden of the mandate.<sup>207</sup> According to the ICBA, community banks would have to implement an entirely new small business lending process to accommodate Section 1071, straying from their nuanced and unique process and revert to a homogeneous process that could drive small business credit out of small banks and reduce access to credit for small businesses with unique credit needs.<sup>208</sup>

## VI. CONCLUSION

Section 1071 seeks to facilitate enforcement of fair lending laws and provide a means for the public to determine unmet needs in the small

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200. Anthony Sharett, *CFPB HMDA Expansion Delivers New Challenges to Banks and Lenders*, 35 *BANKING & FIN. REP.* 1, 3 (2016).

201. *Id.* at 1.

202. *Id.* at 3.

203. Quaadman, *supra* note 168, at 7; Thomas, *supra* note 50, at 13.

204. Quaadman, *supra* note 168, at 7.

205. Thomas, *supra* note 50, at 5.

206. Thomas, *supra* note 50, at 5.

207. Thomas, *supra* note 50, at 7.

208. Thomas, *supra* note 50, at 5.

business lending market by requiring financial institutions to compile, maintain, and report information concerning credit applications made by women-owned, minority-owned, and small businesses.<sup>209</sup> These are very important goals, because of the crucial role small businesses play in our economy.<sup>210</sup> However, too broad of an imposition of heavy compliance costs by the implementation of the rule could be self-defeating and leave these small businesses worse off by putting community banks at risk of failure, thereby restricting access to credit for those businesses.<sup>211</sup> The best way to achieve the goals of Section 1071 while not imposing undue compliance burdens on community banks would be to provide an exemption from the rule's requirements for community banks with under \$50 million in assets.<sup>212</sup>

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209. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 1071(a), 15 U.S.C. § 1691c-2 (2016).

210. *See* CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 3 (explaining that small businesses are vital in fostering community development and fueling economic growth, they are the primary source of income for many owners and employees, and when they are successful, their communities create positive trends in local incomes, employment rates, and poverty rates).

211. *See supra* Part IV.

212. *See supra* Part V.

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