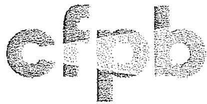

1700 G Street NW, Washington, DC 20552

April 3, 2013

Briefing Memorandum for the Director

AUTO FINANCE DISCRIMINATION INITIATIVE UPDATE MEETING

DATE	April 4, 2013
TIME	15:30
LOCATION	3077
PARTICIPANTS	Steve Antonakes, Garry Reeder, Mike Gordon, Chris D'Angelo, David Silberman, Meredith Fuchs, Patrice Ficklin, Kent Markus, Rick Hackett, Eric Reusch, Ori Lev, Steve VanMeter, Katherine Gillespie, Rebecca Gelfond, Brian Kreiswirth, Evan White

The purpose of this meeting is to reconsider the potential market-wide solutions to the consumer harms caused by dealer markup. Those harms include the discrimination that has thus far been the focus of our supervisory and enforcement efforts, and they also include the potential unfairness of the practice of markup itself, which is not transparent and may cause uncompetitive market outcomes.

A key question for the Bureau is whether we want to affirmatively pursue the elimination of dealer markup qua markup. Our prior cross-Bureau deliberations have concluded that we should not, and that our goal instead should be to address discrimination resulting from markup, and if those efforts led indirect auto lenders to abandon markup in favor of flat fees or other, less problematic compensation practices, then the industry's elimination of markup would simply be an additional benefit from our ECOA-based supervision and enforcement efforts. Our messaging in and surrounding the release of the Compliance Bulletin was consistent with that prior decision. We stated that in addressing discrimination, indirect auto lenders may 1) *retain* markup policies and enhance their compliance management systems, or 2) abandon markup policies and utilize alternative compensation structures, such as flat fees. Further, the Bureau has stated that we are not seeking the elimination of markup per se, but rather the elimination of discrimination resulting from markup.

By the end of this month, the Auto Finance Discrimination Initiative will have █ of the top █ indirect auto lenders under examination or investigation. Disparities have already been found in the █ institutions for which we have data, and analysis of the remainder will continue through the summer and into the fall. It is noteworthy that our supervision activity alone has prompted numerous press articles and expressions of interest from █ and other lenders in a global solution. This interest was increased by last month's release of a Compliance Bulletin, and will likely be further intensified by the launch of seven nonbank enforcement actions together with the Department of Justice.

We have identified two methods of affirmatively seeking a global solution: 1) rulemaking or 2) a legally binding consent agreement (or agreements) with a market-tipping percentage of indirect auto lenders. Before proceeding, we should consider the goal of such affirmative efforts. This document first discusses the potential downstream global impact of our seriatim supervision and enforcement actions, and then discusses the risks and benefits of the Bureau affirmatively engaging in rulemaking or brokering a market-tipping consent agreement.

1. Bank Supervision and Nonbank Enforcement

We have recognized that while our bank supervision and nonbank enforcement activities would lead to seriatim resolutions, these efforts could prompt indirect auto lenders to express interest in working with the Bureau to eliminate markup across the market.

Our past cross-Bureau discussions considered ways to encourage such an outcome, specifically by prompting nonbank interest in our efforts. For example, we agreed to continue to press nonbank trade associations and lenders to provide anonymized data to the Bureau for use in a whitepaper on markup (bank trades had previously agreed to provide such data, conditioned on participation by nonbanks), and to partner with the Department of Justice to reach indirect auto lenders through an ECOA-based enforcement strategy.[1] In addition, we engaged in several industry speaking engagements leading up to the release of a Compliance Bulletin. Press response from these activities indicates that auto lenders have gotten the message that we are concerned about discrimination in dealer markup and several press articles suggest that we may be concerned more generally about the practice of markup itself.[2] In addition, at the recent CBA conference, some industry representatives

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[1] We also explored whether the release of the proposed Auto Finance Larger Participant Rule could be timed to coincide with the commencement of nonbank enforcement activity to signal nonbank lenders of the Bureau's interest, but the timing of other priority LP rulemakings made this infeasible.

[2] *See, e.g.*, Rachel Witkowski, *CFPB Warns Banks on Indirect Auto Lending*, AM. BANKER (Mar. 22, 2013) (noting that "[o]bservers have said the agency is trying to force auto dealers to agree to flat-fee compensation by placing pressure on lenders through existing fair lending laws" and that "[t]he bulletin could prompt system-wide change."); Rachel Witkowski, *Car Dealers Fight Back Against*

suggested that eliminating markup might be the best solution. Thus, it is possible that our supervisory and outreach efforts will have a "coattail effect" that causes lenders who are not under current Bureau scrutiny to shift away from markup, in which case our pipeline of additional supervisory and enforcement matters would serve to increase that likelihood. (See slide #1 of the attachment.) We know that, at a minimum, there is significant interest by industry in aligning their fair lending compliance management systems with the Bureau's Compliance Bulletin. The chart below summarizes several considerations related to relying solely on supervision and enforcement activity to address market-wide discrimination specifically, and markup generally:

	Supervisory MOUs	*Individual Consent Orders*
Consumer Remediation	Damages	Damages, CMPs
Prospective Consumer Relief	Downpayment assistance, car-buying education; strong CMS; voluntary elimination of markup	Downpayment assistance, car-buying education; strong CMS; voluntary elimination of markup
Risks	Challenges in giving specific CMS guidance; first-movers on markup risk loss of market share; nonpublic action may not result in global impact	Challenges in giving specific CMS guidance; first-movers on markup risk loss of market share
Resources	SEFL commitment to █ in-depth exams may be insufficient for global impact	SEFL commitment to █ investigations and █ enforcement matters (facts warranting) may be insufficient for global impact
Next Steps	Additional compliance bulletins providing more clarity re: CMS	Migration of supervisory matters; nonbank launch

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CFPB Auto Financing Rule, AM. BANKER (Mar. 25, 2013) ("The agency is encouraging lenders to adopt a flat-fee model for dealer compensation."); Jim Henry, *It's Official: CFPB's Gunning for Dealer Reserve*, AUTOMOTIVE NEWS (Mar. 27, 2013) ("CFPB Director Richard Cordray left no doubt the bureau takes a dim view of any dealer discretion in determining a customer's final interest rate on a car loan . . . .").

2. Rulemaking

PRIOR DECISION AGAINST RULEMAKING

In September 2012, the Bureau considered rulemaking as a way of reaching the entire indirect auto lending market. At that time, four options were considered:

1. A UDAAP rule that would address the practice of markup directly, potentially banning it.
2. An ECOA rule that would clarify the liability of indirect auto lenders under ECOA for disparities caused by markup.
3. A TILA/§1032 rule that would require markups to be disclosed to consumers.
4. An advance notice of proposed rulemaking (ANPR) that would signal the CFPB's focus on dealer markup and highlight the potential UDAAP, ECOA, and TILA issues, without deciding upon an approach.

With input from SEFL, RMR, LD, and the Deputy Director, the Bureau opted not to pursue a rulemaking for these reasons:

1. The contemplated UDAAP rule might exceed our regulatory authority because the potentially unfair, deceptive, or abusive actions are ostensibly those of the dealers, over whom we have no regulatory authority. In order to impose a regulation on indirect auto lenders, we would need to advance some theory as to the reason why a practice integrally involving dealers was nonetheless subject to Bureau authority (e.g., aiding and abetting, agency liability, or an interpretation of §1031 focusing only on lenders) and those legal theories are not as strong as we would like. We were also concerned that a UDAAP rule would provide little principled basis on which to distinguish markup from other, similar practices that are ubiquitous in retail transactions. Aside from the legal concerns, the UDAAP option also would have exposed the Bureau to charges that were seeking to circumvent Dodd-Frank's carve-out for auto dealers.
2. The contemplated ECOA rule was unnecessary because the goal of that rule would be essentially to restate the law as it already stands, and that could be accomplished with a compliance bulletin (such as the one recently published). Rather than a rulemaking, the Bureau chose to pursue option #2 by issuing a compliance bulletin explaining the applicability of ECOA to indirect auto lenders.
3. A TILA/§1032 rule might prove insufficient to address the problem because disclosures of similar rate markups (i.e., YSPs) did not work in the mortgage context due in part to their complexity. In addition, consumer disclosures would need to be made by auto dealers, over whom the Bureau lacks jurisdiction.

CURRENT POTENTIAL FOR RULEMAKING

Despite our prior rejection of a rulemaking approach, the fact that our supervisory and outreach activity may be generating the desired market-wide interest in a global solution militates in favor of reconsidering a rule addressing dealer markup. However, it is important to note that if a decision were made to proceed by rulemaking, this would necessitate a change in other rulemaking priorities and would not result in a final rule until the end of 2014 at the earliest.

The rulemaking options now being considered, and reflected on slide #2 of the attachment, are:

1. **ECOA**: To ban compensation practices related to the terms and conditions of an auto loan, based on the substantial risk that they cause discrimination.
2. **UDAAP**: To ban compensation practices related to the terms and conditions of an auto loan, based on the substantial risk that they cause unfair, deceptive and/or abusive practices.
3. **TILA/§1032**: To require that markups be disclosed to consumers.

Regardless of whether a rulemaking focuses on banning markup or on consumer disclosure, the potential benefits would be its potential to increase market transparency, eliminate the ability for dealers to price discriminate, and thereby generate consumer surplus. Consumers are often unaware of the practice of dealer markup, their ability to negotiate the interest rate of their car loan, and the price of loans for similarly-situated consumers.[3] It is possible that disclosing or eliminating dealer markup would create more transparent pricing, and thereby improve competition. It is worth noting, however, that if markup were eliminated, it is not entirely clear how the market would respond. Dealers would undoubtedly seek to replace that revenue stream, and the ultimate impact on consumers is unknown.

There are several concerns with a rulemaking approach. First, the legal authority for all of the potential rulemakings is unclear given our lack of authority over dealers. Second, the Bureau would face considerable pressure from external groups if it sought to regulate or ban the practice of markup itself — pressure that should not be underestimated. The rule could be perceived as an attempt to circumvent our lack of regulatory authority over auto dealers, and that presents both legal and political risks that our rule could be overturned by a court or by Congress. A disclosure approach might spur somewhat less resistance, but we lack jurisdiction over the parties who would be required to make the disclosures: auto dealers.

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[3] A recently completed survey by the Center for Responsible Lending found that only 26% of recent carbuyers negotiated their interest rate, while over 60% negotiated the car's price.

Third, a decision to write a dealer markup rule would require resource tradeoffs, sacrificing current rulemaking commitments. Finally, even with these tradeoffs the most optimistic date for a final rule would be the end of 2014. The chart below summarizes several considerations related to relying on Rulemaking to address market-wide discrimination specifically, and markup generally:

	A Rule Banning Markup (ECOA or UDAAP)	*A Rule Requiring Disclosure (TILA)*
Consumer Remediation	None	None
Prospective Consumer Relief	Elimination of compensation practices based on loan terms; perhaps enhanced competition	Disclosures that address the current information imbalance by revealing the buy rate and marked up final rate, and perhaps enhance competition
Risks	Unclear legal authority; need for robust factual predicate; lack of authority over dealers; likelihood of judicial and congressional challenges to a rule	Limited value of disclosures to consumers, especially vulnerable consumers; lack of authority over dealers, need for FRB collaboration
Resources	Tradeoffs mean delaying current rulemaking commitments; best-case timing for a final rule is end of 2014	Tradeoffs mean delaying current rulemaking commitments; best-case timing for a final rule is end of 2014
Next Steps	Additional legal research	Additional legal research

3. Market-Tipping Consent Order

Our seriatim actions have the express purpose of eliminating discrimination at the selected institutions, either through considerably enhanced compliance programs or through the elimination of dealer markup. However, our outreach strategy, including the compliance bulletin, is aimed at spurring similar market-wide changes. These actions may ultimately prove successful in generating a coattail effect, but another enforcement-based option is to attempt to enter into a consent order with several auto lenders, enough to tip the market away from discriminatory practices in particular, or markup more generally. While it is

possible that we could pursue a global solution with the goal of prescribing effective dealer markup compliance management systems, we believe that many indirect auto lenders would share the Bureau's interest in instead using this opportunity to lead an effort to move the market away from dealer markup practices altogether. Below we walk through several options for achieving a global consent order that addresses discrimination through the elimination of markup, laying out some (but perhaps not all, as these have not yet had the benefit of thorough research) of the attendant risks and concerns.

"ENFORCE" AUTHORITY — FACTUAL PREDICATE AND TIMING

In the past, our consent orders have relied upon our authority to "enforce" consumer laws under a cease-and-desist proceeding. § 1053(a), (b). However, those actions require that we present "facts constituting the alleged violation[s]." § 1053(b)(1)(A). We currently have such facts for the first five banks under examination, which together comprise only 17% of the auto lending market. We have every reason to believe that, if we were able to reach a consent agreement with this group of banks, it would not be sufficient to tip the market away from the practice of markup, mostly because market share would simply shift to other indirect lenders, including the captive nonbanks, who were not parties to the agreement.

The best-case timing for analyses of the additional [redacted] banks and [redacted] nonbanks is this fall and winter, but we expect to encounter resistance from at least some of the nonbanks as well as significant data integrity challenges in their responses to our information and data requests. This means that our ability to use the "enforce" authority to broker a global settlement may be significantly restricted in the medium, and potentially long, term because we lack the necessary factual predicate. Moreover, even assuming we had a sufficient factual predicate as to these institutions, they may be insufficient to tip the market, and obtaining evidence to support a factual predicate of additional entities would require significant additional resources.

"ENSURE" AUTHORITY — LEGAL CONCERNS

Because our "enforce" authority presents timing issues and concerns about lack of factual predicate, we have been exploring other potential legal vehicles (see slide #3 of the attachment). One possibility is to use the Bureau's authority to "ensure" compliance with consumer laws through a proceeding under § 1053(a). Potentially, this type of proceeding would not require "facts constituting the alleged violation[s]," but would instead require some lesser factual predicate, perhaps a substantial risk of a violation that would trigger our authority to "ensure" compliance even where no violation had yet been found. However, one of the detriments of using the "ensure" authority is that it probably limits us to obtaining prospective relief, because the verb "ensure" is arguably future-oriented.

We have never explicitly used this authority and it carries significant risks. First, the triggering factual predicate is not defined in Dodd-Frank, would need to be internally

defined, and that definition risks slippage over time. Second, although the language of § 1053(a) seems to contemplate *non*-cease-and-desist proceedings, the text of the statute appears to give no right of judicial review to such proceedings. This may simply be a scrivener's error, but it presents complications in our use of § 1053(a). However, in the context of a consent decree, that risk could be somewhat lessened if the consenting parties waived review. Third, there is a risk that the auto dealers could bring a legal challenge to an agreement that eliminates an important source of their compensation without opportunity for their input. Finally, all of these risks point to the broader political and prudential issue, which is that using the "ensure" language potentially expands our authority beyond simply enforcing against violations, and risks the perception that we are strong-arming entities into consent agreements without any basis for a violation.

"CONDITION IMPOSED IN WRITING" AUTHORITY — LEGAL CONCERNS

Another potential legal vehicle for a consent order is to use our authority to enforce "any condition imposed in writing on the person by the Bureau." § 1053(b)(1)(A). This language is a second method of establishing a factual predicate for a cease-and-desist proceeding, but it is unclear how this phrase applies to the Bureau. The phrase itself was borrowed from legislation that applies to the prudential regulators, where they impose conditions "in connection with the approval of any application or other request by the insured depository institution." 12 U.S.C. § 1818. These conditions are imposed in the context of mergers, acquisitions, charter applications, and the like, and there is no direct analogy for the Bureau.

The chief concern with proceeding with this option is that it could be perceived as too broad an expansion of our authority. If we can impose conditions in writing, and if those conditions can be enforced via a cease-and-desist proceeding, then that arguably widens our authority without adequate limits or controls on that discretion. The risk of legal challenge might be lessened if such conditions were imposed as part of a consent order, but our sole reliance on this authority might draw attention to the lack of safeguards against arbitrariness.

AGREEMENTS ENFORCED IN CONTRACT — STRATEGIC CONCERNS

The last legal vehicle we have explored is an agreement enforceable only in contract, such as an agreement to halt the practice of markup. As legal consideration for the contract, the Bureau might offer some sort of prosecutorial immunity for the signatories. Though these agreements offer simplicity, they suffer from a potential lack of enforceability. A court may not require specific performance of such a contract if one of the entities were to breach the agreement. In such an instance, our fallback position would be to proceed with the enforcement action from which we agreed to refrain, but we would be no closer to having the facts supporting such a prosecution than we were when the agreement was signed, providing little incentive for the entities to comply with the agreement. Alternatively, if we already had

the facts necessary to support enforcement action upon signing, then our "enforce" authority would offer a more durable alternative.

The chart below summarizes several considerations related to all of the legal vehicles described above, which would seek to tip the market through a consent order that addresses market-wide discrimination specifically, and markup generally:

	A Market-Tipping Consent Order Providing for Remedial and Prospective Relief	*A Market-Tipping Consent Order Providing for Prospective Relief Only*
Consumer Remediation	Damages, CMPs	None
Prospective Consumer Relief	Elimination of compensation practices based on loan terms; perhaps enhanced competition; downpayment assistance; car-buying education	Elimination of compensation practices based on loan terms; perhaps enhanced competition; downpayment assistance; car-buying education
Risks	Unclear legal authority; need for robust factual predicate in light of remediation; focus on past conduct will dampen non-target interest in participating	Unclear legal authority; need for factual predicate; tangible consumer benefit is diminished by absence of damages
Resources	Process can become quite lengthy, protracted and political; interagency participation requires coordination; comparable processes have taken two years; significant resources required to obtain required factual predicate	Process can become quite lengthy, protracted and political; interagency participation requires coordination; comparable processes have taken two years
Next Steps	Additional legal research	Additional legal research

Attachment(s)

Tab 1: Slides 1, 2 and 3