MEMORANDUM

From: Patrice Ficklin; Kent Markus
Through: Steve Antonakes
To: Richard Cordray; Raj Date
Re: Auto Finance Discrimination Action Plan

Background and Summary Recommendation: The Bureau's priority-setting process identified auto finance discrimination, with specific focus on dealer markup, as a Bureau priority. This "Horizon 2" work concluded with a determination to pursue an ECOA-based approach with a hope that such an approach might move the market towards elimination of dealer markup. The completion of several indirect auto lender fair lending examinations prompted SEFL to consider how to execute the broadly-articulated Bureau objective of attacking auto finance discrimination while also considering the allocation of SEFL resources towards competing commitments and objectives. We considered whether the resources necessary to execute that objective should be marshaled at this time given that auto finance discrimination is a Bureau priority, whether a different strategy would allow us to move on the objective in some other way that would be less disruptive of other enforcement activity currently underway, or whether the effort should be postponed until resources are freed up (as has been done with various rule-making objectives).

Animating our discussions was the determination that auto finance discrimination is a Bureau priority and a specifically articulated priority of Fair Lending since the development of its June 2011 strategic plan. This makes it important for us to find an approach to attacking this problem that does not postpone efforts on this front to another day – a day when freed up resources can be applied to it. Our discussions have focused on how to achieve the greatest benefit for the resource investment SEFL makes in this effort. This has required consideration of a number of factors, each discussed below.

After engaging in these discussions we have reached consensus on a recommended approach. We propose that we conclude the exams underway and immediately proceed with efforts to effectuate remediation of the fair lending violations evidenced through those exams. We have dedicated the resources to choose as many as three banks for public enforcement action and attempting to negotiate consent orders aimed at achieving implementation of acceptable fair lending compliance management systems regarding indirect auto financing. We would expect such orders to contain special requirements to mitigate against the use of the discretion inherent in dealer markups that too often results in discriminatory lending.

We would also, at the appropriate time, issue a compliance bulletin that would provide guidance on the application of Regulation B and caution bank and nonbank indirect lenders that we expect compliance with fair lending obligations in the context of auto financing.

And we would select – after narrow information requests to what we anticipate to be [redacted] – [redacted] We would attempt to select those evidencing the greatest level of discriminatory lending behavior and dedicate resources to those cases.

It is important to note that the central goal of our recommended approach is to remediate the problem of fair lending in auto financing as we encounter it through exams and investigations, rather than trying to use fair lending violations as a lever to push the industry to abandon dealer markups altogether. While we hope the resolution of our supervision and enforcement activity may encourage lenders to abandon markups altogether, that is not the likely outcome given the significant risk that lenders who unilaterally eliminate markup may simply lose market share to those that do not. Rather, we recommend that the enforcement actions attack the problem of discriminatory markups not instrumentally, but because fair lending is an important goal in and of itself.

We offer more detail in the sections below. We first present a problem statement, then use exam data to estimate the scope of consumer harm, and articulate our goal as well as our strategy and implementation plan for achieving it. We believe that the risk of any given strategy is an important part of our evaluation, so we have a section devoted to risks and challenges. Finally, we conclude with estimates of the Enforcement and Fair Lending resources that would be required, and the expected impact of achieving our goal.

Problem Statement: When consumers finance an automobile purchase through a dealer, both bank and nonbank indirect auto lenders typically establish a base interest rate (or "buy rate") for each consumer based upon an analysis of objective credit criteria and maintain policies that allow auto dealers significant subjective discretion to mark up risk-based interest rates. These markups are not transparent to consumers, who may be unaware that the dealer is not acting in their best interest, and our supervisory data show that African American and Hispanic borrowers pay more in markups than similarly situated non-Hispanic Whites. Indirect auto lenders' participation in the auto finance credit transaction renders them "creditors" under the Equal Credit Opportunity Act (ECOA), and therefore responsible for any disparate treatment or disparate impact in dealer markups on a prohibited basis, such as race, ethnicity, and sex.

Scope of Problem: We have data indicating that dealer markups are widely used, and that the resulting discrimination is market-wide.

- 2011 data from [redacted] indirect auto lenders ([redacted] market share) show disparities of 27 basis points for African Americans and 18 basis points for Hispanics.[1] On average, African-American borrowers would pay $226 more in interest per

[1] ILLM has reason to believe that disparities may be much larger for nonbank indirect lenders, largely because their compliance systems are believed to be less robust.

transaction over the life of the loan, and Hispanic borrowers $158 more, than similarly-situated non-Hispanic white borrowers.

- Extrapolating these figures to the market as a whole, African-American and Hispanic borrowers would pay $643 million more in interest than non-Hispanic White borrowers over the life of their loans for transactions consummated in each origination year if the loans were held to term. Markets reports that the auto finance market continues to grow from its size in 2011, and that this aggregate harm estimate is therefore a lower bound.[2]
- In addition to this out-of-pocket harm, minorities also suffer indirect economic harm and non-economic harm as a result of this illegal discrimination.
- Markets has estimated that actual interest payments represent 56% of lifetime interest based on overall prepayment trends, but discounting is difficult without knowing precisely who prepaid and in what manner.[3] Nevertheless, taking the 44% discount rate as an upper bound reduces the aggregate annual direct economic harm (out-of-pocket costs) to no less than $360 million.[4]

Goal: The goal of our proposal is to use SEFL tools against a critical mass of bank and nonbank indirect auto lenders to remedy discrimination in a manner that compensates consumers harmed by discrimination and prevents future discrimination. Though this activity may move the market towards elimination of dealer markup, that is not the primary objective. Effective prospective remedies include:

- The elimination of markups or significant modifications to current markup policies (e.g., more effective caps); and
- Enhanced fair lending compliance management programs.

As discussed below, while the *elimination* of markups is one possible resolution, settlement negotiations with individual lenders may generate proposals to *modify* current markup policies in a manner that effectively addresses the fair lending risk while falling short of eliminating dealer markup. In such an instance, where the lender offers a resolution that effectively mitigates fair lending risk without eliminating markups, the priority will be to accept such a settlement offer to effectively address discrimination and move the market towards a better model for markup policies, rather than insisting on elimination of markups.

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[2] These estimates are also limited to the harm suffered by African Americans and Hispanics. Although our review of supervised entities has not yet revealed any significant disparities between the markups charged to men and women, such discrimination may exist, which would further increase the estimates of aggregate market harm.
[3] For example, the 44% figure assumes that prepayment occurs slowly over time, in the form of a few extra dollars each month, whereas at least some, if not most, prepayment activity occurs at a single point during the term of the loan. As we execute the strategy proposed in this memorandum, damages calculations will be discounted as warranted by the facts and circumstances in each particular matter, rather than based on market-wide estimates.
[4] The market impact of eliminating discriminatory markup is uncertain. Dealer compensation may become more transparent, thereby making the market more competitive and increasing total consumer benefit. Alternatively, dealers and indirect lenders may simply redistribute discriminatory overpayments across the total car-buying population, thereby decreasing the out-of-pocket gains for minority borrowers, who would no longer be subject to discriminatory markup but may not realize out-of-pocket savings equal to the total sum of discriminatory markups.

Proposed Strategy: The proposed action plan dedicates resources to pursue as many as three bank and two to three nonbank indirect lenders through enforcement, with the goal of entering into settlement discussions with these entities (should the facts warrant enforcement action) and pressing them to eliminate or significantly modify their use of dealer markup in order to address discrimination.

Although eliminating the discriminatory disparities is the principal goal of these actions, we are mindful that requests for wholesale elimination of markup risk "squeezing the balloon" and driving business to other entities against whom we are not taking action. Markets has stated that while lenders would like to abolish markup, no single actor is willing to suffer the competitive disadvantage that would come from changing their markup program unless others choose to or are forced to follow suit. Markets also says this is a "bet the company" issue for lenders, which means if we target a lender in isolation they are likely to fight very hard against any Bureau action. We also understand from Markets that some lenders have stated that if they are forced to eliminate markup or significantly modify their own markup policies but there is no market-wide change, they may choose to withdraw from the market rather than compete against other lenders on an uneven playing field.

In order to mitigate these risks, we will attempt to coordinate the announcements of settlements and/or lawsuits wherever feasible. Moreover, coincident with these settlements or lawsuits, we expect the Bureau to publish a compliance bulletin providing guidance on the application of Regulation B, discouraging unmonitored and uncontrolled markup and encouraging industry trade associations to speak on the topic. The hope is that this critical mass of activity will drive other market actors to adopt alternative compensation structures or modify their behavior, thereby eliminating discriminatory markup as a practice throughout the industry. While best efforts will be made to achieve the sort of coordination of events that might "move the market", we think it is, in fact, unlikely that such coordination will be practically feasible and expect that seriatim resolution of the discriminatory conduct identified at various lenders will be the more likely path. If, as a result of being required to address their discriminatory practices, some lenders choose to exit the market rather than comply with the fair lending laws, we do not see that as a market choice with which the Bureau should interfere.

Short of a rule, we cannot require lenders to eliminate dealer markups altogether, but we can require them to comply with the fair lending laws. Focusing enforcement resources on negotiations with and investigations of various lenders regarding discriminatory markup, rather than on achieving coordinated market-wide adoption of a solution not expressly mandated by law (i.e. – the banning of dealer markup altogether), eliminates the necessity of applying significant simultaneous enforcement resources in a manner that has a high likelihood of not changing the market as a whole.

Instead, the joint recommendation of Fair Lending and Enforcement is that we seek fair lending compliance through public enforcement actions at as many as three banks, that we signal the market about Bureau expectations in that regard through a bulletin accompanying the first of those actions, and that we begin efforts to identify two or three nonbank entities that we will

investigate, in a conventional manner, for fair lending violations associated with loans they fund that have a dealer markup component.

This approach would still require significant enforcement resources from both Offices, and would require Enforcement to add auto finance discrimination as a resource allocation priority, replacing student loan refund cards. We think this is an appropriate reallocation of priority resources. Importantly, it would allow us to stretch out the application of resources to handle these matters without the need for the simultaneous application of resources aimed at achieving an extremely difficult outcome. To the extent individualized enforcement activity results in a "squeezing of the balloon," we will then have to consider what Bureau tools and resources may be most appropriate to apply to the problem at that point in time.

Proposed Implementation of the Strategy:

1. ***Supervisory Examinations (Offices of Supervision and Fair Lending)***

- Complete supervisory examinations of [redacted] auto lenders ([redacted]). The status of current/proposed examinations is depicted below:

Bank	Status	Next Step
[redacted]	Fair Lending PARR letter undergoing SEFL, Legal, and Regs review.	Send Fair Lending PARR letter.
Ally Financial (nonbank affiliate)	Fair Lending PARR letter will be drafted using [redacted] "template".	Send Fair Lending PARR letter.[5]
[redacted]	Fair Lending PARR letter will be drafted using [redacted] "template".	Send Fair Lending PARR letter.
[redacted]	Preliminary data analysis complete.	Comparative file review, then draft Fair Lending PARR letter.
[redacted]	Evaluating supplemental data and	Research conducting analyses;

[5] In the event that the Office of Fair Lending is considering referring an institution to the Department of Justice under the ECOA for a pattern or practice of discrimination, it will send a Fair Lending Potential Action and Request for Response (PARR) letter to the institution.
[6] In addition to the pipeline of supervisory matters described above, Supervision and Fair Lending have also evaluated fair lending compliance programs at several other indirect auto lenders, including [redacted]. These reviews did not include in-depth data analyses, though we noted that each of these entities maintained systems for identifying and addressing dealer markup disparities.

	information from bank.	results expected this week.
	Exam scheduled for	
	Proposed in RAM prioritization process;	

- While all discrimination findings will be remediated, we anticipate choosing no more than t lenders to pursue through enforcement based on the weakness of the lender's fair lending compliance management systems, the severity of the disparities identified, and the extent of consumer harm, among other factors. To the extent additional lenders with markup disparities are subsequently identified in the supervisory process, we will evaluate at that time whether to pursue those concerns through enforcement, supervision, rulemaking, and/or other Bureau tools.
- These matters will likely involve referrals to and coordination with the Department of Justice, and the DOJ may propose expanding the scope of enforcement action both in terms of the entities subject to public enforcement, and also in terms of the scope of a particular investigation. Were this to occur, we would have to make difficult decisions about whether to expand the already substantial enforcement resource commitment being applied to this effort.

2. ***Enforcement Activity (Offices of Enforcement and Fair Lending).***

- As noted above, we will dedicate resources to pursue as many as three bank indirect lenders through public enforcement action arising out of the Bureau's supervisory activities.
- We will also pursue lenders through investigation for public enforcement action. To reduce the risk of challenge or non-compliance, we envision issuing streamlined voluntary information requests to subjects jointly with the DOJ for the purpose of identifying the best targets for further investigation and enforcement action (if warranted). Whether to pursue the remaining lenders through enforcement as separate cases would be evaluated at a later date; in any event, the information obtained could be used to inform our auto finance larger participant rule and subsequent supervisory activity.
- The following auto lenders were tentatively selected for possible investigation and to receive the initial information requests:
    - American Honda Finance Corp.

- The criteria utilized for selection included
  - [redacted]
  - [redacted]
  - [redacted]
  - [redacted]

3. ***Pursuit of Voluntary Solution (RMR and Office of Fair Lending)***. Because we have limited ability to directly impact the demand (dealer) side of this equation, even if we were successful against the [redacted] lenders we anticipate choosing for enforcement, there is still a risk that the remaining actors will not follow suit, and instead grab the new market share from the settling parties if they can offer richer incentives to dealers. Markets' view is that the lucrative and liquid nature of this market is such that [redacted] lenders are unlikely to change their conduct absent a credible threat of enforcement action. Whether the above strategy would suffice as such a threat is an open question, but the likelihood of this risk will vary inversely with the percentage of the market share that our enforcement actions reach.

- To address this risk, we will issue a Compliance/Supervisory Bulletin that
  - Is official Bureau regulatory guidance describing how assignees who "regularly participate" in credit transactions are creditors under ECOA, citing examples from indirect auto lending;
  - Is expressly applicable to all indirect auto lenders, regardless of charter type; and
  - Describes our auto finance examination activity and findings, and sets forth the elements of a robust fair lending compliance management system:
    - Statistical analysis of dealer markups;
    - Fair lending training for all employees involved in auto finance;
    - Fair lending policies and procedures governing all aspects of the transaction between the indirect auto lender and the dealer;
    - Fair lending letters to all participating dealers explaining ECOA, articulating the dealer's obligation to mark up interest rates in a non-discriminatory manner, and stating the lender's expectations with respect to ECOA compliance;
    - Prompt corrective action against offending dealers, including eliminating any dealer markup or excluding dealer from future participation with the lender, when statistical analysis identifies disparities on a prohibited basis; and
    - Prompt remuneration for any consumer when statistical analysis identifies disparities on a prohibited basis.

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[7] Fair Lending is conducting a review of Consumer Response and Sentinel complaints involving auto finance. It is possible that this review may warrant modifications to the list of tentatively selected [redacted] auto lenders.

- We also would analyze anonymized [redacted] data obtained via the [redacted] [redacted], and continue to pursue the participation of [redacted] via outreach to industry representatives.

Risks and Challenges: Regarding timing, our first discussions with industry participants regarding a dealer markup "solution" will involve those entities that we address via supervision and through public enforcement actions arising from supervision. As noted in the table earlier in this memorandum, there are several exams in the closing stages, and we expect to move forward with setting the terms of MOUs and seeking settlement authorization with some of those institutions. Realistically, we believe that the resolution of the first few supervisory matters will likely result in MOUs and consent orders requiring significant changes to markup policies that address the identified discriminatory harm at each particular institution, and ultimately may move the market in a direction that benefits consumers, without eliminating markup.

There are also possible legal challenges that could create litigation risks should the matters require litigation. Indirect auto lenders may argue that they are not liable under ECOA because they do not regularly "participate" in the credit decision or because they are assignees with no knowledge of allegedly discriminatory actions taken by the dealers who originated the loans. For example, [redacted] entities under current examination for their markup practices have argued to the Bureau that they are not creditors under ECOA. However, every court that has addressed such issues has found the indirect auto lenders to be creditors who are liable under ECOA principally based on the fact that they maintained policies authorizing dealers to subjectively mark up interest rates.[8] In addition, courts have looked at other indicia of "participation," including the fact that indirect lenders typically make determinations of creditworthiness, establish buy-rates and maximum markups, process loans in accordance with their policies and procedures, bear the risk of default, and compensate dealers for the markup.[9] Further, because markup policy changes can alter a lender's market share in significant ways and, as noted above, Markets has characterized this as a "bet the company" issue, we should expect at least some, if not all, of the nonbank entities to fight us very hard each step of the way. This impacts resource allocations (discussed further below) and our ability to coordinate enforcement actions.

Resources Required: The Offices of Enforcement and Fair Lending have estimated the resources required to undertake the enforcement activity described above. These resources do

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[8] See Coleman v. General Motors Acceptance Corp., 196 F.R.D. 315 (M.D. Tenn. 2000), vacated and remanded on unrelated grounds, 296 F.3d 443 (6th Cir. 2002); Jones v. Ford Motor Credit Co., 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002); Smith v. Chrysler Fin. Co., 2003 WL 328719 (D.N.J. Jan. 15, 2003); Osborne v. Bank of America, Nat'l Ass'n, 234 F.Supp.2d 804 (M.D. Tenn. 2002); Wise ex rel. Estate of Wilson v. Union Acceptance Corp., 2002 WL 31730920 (S.D. Ind. Nov. 19, 2002).

[9] Institutions may also argue that Wal-mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011), negates anti-discrimination suits based on discretionary policies, but the holding of Wal-Mart is limited to the class certification context and thus inapplicable to the CFPB because it is a government agency not subject to class certification requirements. In addition, institutions may argue that disparate impact is currently being challenged in the Mount Holly case, currently under certiorari review by the Supreme Court. However, even if that case were to eliminate the disparate impact doctrine under the Fair Housing Act, the same arguments do not apply to ECOA, which has had disparate language in Regulation B for 36 years.

not account for ongoing supervisory activity or the resources necessary to prepare Bureau guidance on the markup issue. They only account for the enforcement activity associated with bringing [redacted] public enforcement actions arising out of exams, targeting [redacted] lenders for initial streamlined information requests, and bringing [redacted] additional public enforcement actions against [redacted] lenders. Because the resource costs of pursuing this strategy depend in part on the response of the subjects of our actions, we have estimated resources under a best-case and worst-case scenario. We note that Markets has suggested that this may be a "bet the company" issue for lenders and therefore we cannot completely discount the possibility that one or more may fight any enforcement action. If matters are contested they will require significantly more resources than if they are settled.

Fair Lending Enforcement Matters Arising from Exams ([redacted])

- Under a **best-case** scenario, in which the institutions in question do not push back significantly as to our factual or legal conclusions, and accede to public enforcement action, we estimate that bringing these matters to resolution would consume the litigation[10] time of 3 Enforcement attorneys and 0.6 Fair Lending attorneys for a 6 month period (**1.5 ENF LIT FTE, 0.3 FL FTE**).
- Under a **worst-case** scenario, in which [redacted] of the [redacted] institutions push back significantly on facts and law, and strongly resist public enforcement action given market conditions but ultimately agree to settle, we estimate that bringing these matters to resolution would consume the litigation time of 3 Enforcement attorneys and 0.6 Fair Lending attorneys for a 12 month period (**3 ENF LIT FTE, 0.6 FL FTE**).
- NOTE: In the event that one or more of these institutions chose to litigate the matter, the resource expenditure would be significantly higher. We assume that these bank indirect lenders would simply exit the marketplace rather than litigate with the Bureau.

Fair Lending Information Requests and Follow Up ([redacted])

- Under a **best-case** scenario, in which the information request recipients comply voluntarily with our requests, with minimal negotiations and modifications, we estimate that bringing these matters to resolution would consume the litigation time of 2.5 Enforcement attorneys and 0.8 Fair Lending attorneys for 6 months (**1.25 ENF LIT FTE, 0.4 FL FTE**).
- Under a **worst-case** scenario, in which several recipients engage in substantial negotiations regarding production and either refuse to produce any data or produce significantly less information than desired, we estimate that bringing these matters to resolution would consume the litigation time of 4 Enforcement attorneys and 0.8 Fair Lending attorneys for 9 months (**3 ENF LIT FTE, 0.6 FL FTE**).

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[10] Currently the litigation time of an Enforcement attorney represents approximately 55% of their time. Thus, for purposes of these calculations, the litigation time of one Enforcement attorney translates to approximately half of his or her time.

- NOTE: In the event that we chose to pursue CIDs and/or litigation to compel compliance with our requests, the resource expenditure would be significantly higher. Failure to follow up with those who fail to comply entails other risks to the Bureau's reputation.

Fair Lending Full Investigations/Enforcement Actions ([redacted])

- Under a **best-case** scenario, in which the subjects cooperate with additional information requests and agree to non-litigated settlements without substantial pushback, we estimate that bringing these matters to resolution would consume the litigation time of 3 Enforcement attorneys and 0.6 Fair Lending attorneys for 12 months (**3 ENF LIT FTE, 0.6 FL FTE**).
- Under a **worst-case** scenario, in which [redacted] of the subjects are unwilling to settle on acceptable terms and we end up litigating rather than settling the enforcement actions, we estimate that bringing these matters to resolution would consume the litigation time of 6 Enforcement attorneys and 0.6 Fair Lending attorneys for 24 months (**6 ENF LIT FTE for 2 years, 0.6 FL FTE for two years**).
- NOTE: These resource estimates are based on prior scoping and information collection, as noted above. If that step were eliminated, additional resources would be required for investigation.

Resource summary: Depending on the response of the industry, the resource expenditure is summarized in the below table.

		Year 1		**Year 2**		**Year 3**	
		ENF LIT FTE	FL FTE	ENF LIT FTE	FL FTE	ENF LIT FTE	FL FTE
Best Case	Bank ENF	1.5	0.3				
	8 Info. Requests	1.25	0.4				
	3 Investigations	1.5	0.3	1.5	0.3		
	Total	**4.25**	**1**	**1.5**	**0.3**		
	Percent of Capacity	4.9%	16.7%[11]	1.7%	5%		
Worst Case	Bank ENF	3	0.6				
	8 Info. Requests	3	0.6				
	3 Investigations	1.5	0.15	6	0.6	4.5	0.45

[11] These percentages assume a denominator of 6 Fair Lending enforcement attorneys, only 2 of which are currently on board.

	Total	**7.5**	**1.35**	**6**	**0.6**	**4.5**	**0.45**
	Percent of Capacity	8.7%	22.5%	7%	10%	5.2%	7.5%

Trade-Offs: Given Markets' assessment of the importance of markups to lender profitability, it is likely that the resource expenditure will not be at the low end of the spectrum. Enforcement's auto finance allocation is already maxed out with existing investigations and it seems unwise to abandon those promising investigations mid-stream. Thus, we propose adding auto finance discrimination as an Enforcement resource allocation priority, replacing student loan refund cards. We could, perhaps, at some subsequent point in time, also draw from the auto lending pool, but at this time, that pool is tapped out. Of significant importance to Enforcement is the understanding that to the extent the resource draw from the new auto finance discrimination priority category exceeds its capacity (which we think is likely) and consumes general fair lending capacity (which we think is likely), there is a reasonable likelihood that Enforcement would lack capacity for quite some time to initiate other fair lending work that is not otherwise allocated to a specific topical market area (including HMDA-related activity or other Fair Lending priorities). We believe it is reasonable to place this kind of "big bet" in this area, in an effort to remediate auto finance discriminatory lending, but this is a major resource allocation shift not easily replicated.

Potential Impact / Conclusion: Enforcement and Fair Lending are ready to take on illegal discriminatory consumer lending activity. We would seek economic and non-economic damages for past discrimination, as well as the elimination of markups or significant modifications to current markup policies and enhanced fair lending compliance management programs.

The proposed actions, if they ultimately resulted in market-wide impact on discriminatory lending, would mitigate the economic impact of hundreds of millions of dollars in annual discriminatory overpayments currently paid by minorities. It would also have the significant non-economic benefit of eradicating or severely minimizing discrimination in an industry that has long had problems in this area. This benefit cannot be quantified but its value should not be underestimated. Our chances of remediating discriminatory lending at the entities investigated and pursued through enforcement efforts are high. Whether this will result in a market-wide impact on discriminatory lending is much harder to know and our chances of eliminating dealer markup altogether are quite uncertain. The scope of economic and non-economic harm has been identified, as have the remedies we could potentially achieve. The strategy will require significant resources from both Enforcement and Fair Lending and we stand ready to execute the proposed strategy.