

February 20, 2012

DECISION MEMORANDUM FOR RICHARD CORDRAY

From: Patrice Ficklin, Office of Fair Lending & Equal Opportunity
Richard Hackett, Office of Installment and Liquidity Lending

Recommendation:

That you approve the attached Charter for an Auto Finance Discrimination Working Group.

Approve Disapprove Let's Discuss
PC

Background:

The Bureau set its priorities for the first two years through the Workstream A process. Discrimination in auto finance was one of the priorities chosen through that process. The Office of Fair Lending & Equal Opportunity has worked with the Office of Installment & Liquidity Lending Markets and other colleagues at the Bureau to draft the attached Charter that proposes the establishment of an Auto Finance Discrimination Working Group. As explained in detail in the attached Charter, the proposed Working Group will lead the Bureau's efforts to study, investigate, and make recommendations about particular areas of concern in the auto finance market, including subjective markups of interest rates, financing of high margin additional products, and Buy Here Pay Here dealers. The Auto Finance Discrimination Working Group's work will be completed on September 27, 2012 with an options memorandum presented to the Policy Committee. The attached Charter was cleared by the directorates of Fair Lending and RMR and was presented to and cleared by the Policy Committee on February 9, 2012.

AUTO FINANCE DISCRIMINATION WORKING GROUP CHARTER

1.0 Background, Legal Context and Current CFPB Efforts

1.1 Background

After mortgage and home equity loans, auto finance debt is the second largest category of consumer debt in originations in the United States. An estimated 36 million consumers take on approximately \$350 billion in new auto finance debt every year.¹ With the average price of a new automobile exceeding \$29,000, and used cars ranging from \$8,875 to \$16,474 at dealerships², a car purchase or lease is the most expensive financial transaction engaged in by most consumers.

While consumers may seek auto financing directly from a bank or credit union, most seek financing from the auto dealer. The dealer may provide that financing directly, or provide it indirectly via auto financing offered by a third party, such as a bank, captive auto finance company, or specialty lender. In this indirect auto finance model, the dealer acts like a broker³ – significantly influencing and in most cases actually selecting the financing for the consumer from among the loan products offered by third parties. In addition, employees of the dealer, known as the Finance & Insurance (F&I) office, often have the discretion to mark up the interest rate set by the third party before offering the loan to the consumer. This amount is called the “dealer markup.” Dealers derive approximately 50% of their profits from F&I revenues.⁴

Despite the large number of consumers who have engaged in multiple auto finance transactions, the economics of those transactions remain a mystery to most. Sixty-one percent of consumers are unaware of the annual percentage rate on their loan.⁵ In the course of launching a recent series of auto finance roundtables, the Federal Trade Commission (FTC) noted that while financing obtained at the dealership may provide benefits for consumers, it also can be “a complicated, opaque process and could potentially involve unfair or deceptive practices.”⁶ Seventy-nine percent of consumers who finance with the dealership are unaware that the interest rate on their auto loan is able to be

¹ CFPB estimate based on data from Experian, Moody's and CNW Research.

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⁴ “Indirect Auto Lending Industry, Insider's View” presentation to the Federal Reserve Bank of New York by Greg Skurkovich, at 4 and 5.

⁵ D. David & J.M. Frank, “Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses,” Apr. 19, 2011, at 8. <http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups-Executive-Summary.pdf>. (hereinafter, Center for Responsible Lending, “Under the Hood”, April 2011) at 8, citing Capital One Financial Corporation Survey, 2008.

⁶ Public Roundtables: Protecting Consumers in the Sale and Leasing of Motor Vehicles, 76 Fed. Reg. 14,014 (Mar. 15, 2011).

marked up by the dealer.⁷ Each annual cohort of auto finance consumers pays an estimated \$25.8 billion in interest rate markup over the lives of their loans.⁸

Consumer advocates, including the National Consumer Law Center (NCLC) and the Center for Responsible Lending (CRL) have focused on abuses in auto finance. In the late 1990s and into the early 2000s, the NCLC brought several auto finance discrimination lawsuits against indirect auto lenders, whose loans were brokered by, and often marked up by, dealerships. Information from discovery in those cases revealed that among borrowers who financed with dealerships, African American and Hispanic borrowers were subjected to statistically significantly larger interest rate markups than white borrowers. Subjective markups for loans to African American borrowers exceeded markups on loans to white borrowers in amounts ranging from \$350 to \$500. From 2003 to 2007, those lawsuits were settled, and consent agreements were put in place capping dealer markups at 2.5%. The settlements have all expired. It is not certain whether the caps fully addressed the fair lending concerns associated with dealer markups. The extent to which indirect auto lenders are self-monitoring for fair lending issues for compliance with the Equal Credit Opportunity Act (ECOA) also is unknown.⁹

Consumer advocates argue that dealer markups also may constitute an unfair practice because they have the effect of imposing significant and arbitrary hidden fees on millions of consumers. Consumer advocates claim that most consumers whose loans are marked up – at the discretion of the dealer and without regard to default risk – pay far higher interest rates than they would otherwise qualify for. At the same time, according to consumer advocates, consumers are often unaware that the dealer has a strong incentive to markup their loan, which makes them unable to avoid the harm.¹⁰ When the Federal Reserve Board determined that loan brokerage practices in the mortgage context (discretionary markups in the interest rate by brokers and loan officers – commonly called yield spread premiums) was causing harm that was not reasonably avoidable by consumers, it declared the practice unfair and prohibited it for both brokers and lenders. At some point the Bureau may need to determine the extent to which dealer markups are an unfair practice. Conducting the investigation and analysis to support such a determination is not within the initial scope of this proposed working group but may be suggested in a future presentation to the Policy Committee.

In addition to interest rate markups, F&I offices engage in sales of high-margin aftermarket products, including extended warranties, service agreements and guaranteed auto protection,¹¹ to achieve their profit goals. These products typically are all added to the amount financed in an

⁷ Center for Responsible Lending, “Under the Hood”, April 2011 at 8.

⁸ Center for Responsible Lending, “Under the Hood”, April 2011. Industry associations and lenders criticize CRL’s calculation of this figure.

⁹ The Equal Credit Opportunity Act (ECOA) prohibits discrimination in lending. As discussed below, one way in which the CFPB will learn whether indirect auto lenders are self-monitoring for fair lending issues is through the supervisory exam process.

¹⁰ In order to declare a practice unfair, the Bureau must have a reasonable basis to conclude that the act or practice causes or is likely to cause substantial injury to consumers which is (1) not reasonably avoidable by consumers and (2) not outweighed by countervailing benefits to consumers or to competition. Dodd-Frank § 1031(c)(1).

¹¹ To the extent add-ons constitute insurance as defined by state law, the Bureau will not have jurisdiction to regulate these products. Moreover, Regulation B does not apply. As the Staff Commentary provides, “[d]ifferences in the availability, rates, and other terms on which credit-related casualty insurance or credit life, health, accident, or disability insurance is offered or provided to an applicant does not violate Regulation B.” 12 C.F.R. Supp. 1 cmt. 202.7(e)(1).

installment sales contract, and ultimately may affect the consumer's ability to make car payments and negatively skew the loan-to-collateral-value ratio for the loan. Consumers may not be aware of their ability to refuse these products or of the effect of the products on their financing obligations. Given the amount of discretion, and apparent lack of controls or monitoring on the F&I offices, there also is a significant opportunity for discrimination, in addition to the lack of transparency, in the sale of these products. The Working Group's charter would be limited to any potential discriminatory practices and impact associated with packing, not the more general potential unfairness or deception of the practice.

1.2 Legal & Regulatory context:

The Equal Credit Opportunity Act (ECOA) makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis with respect to any aspect of a credit transaction, including auto finance transactions.¹² The ECOA defines "creditor" as "any person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."¹³ Regulation B, the ECOA's implementing regulation, further defines "creditor" as including any "person who, in the ordinary course of business, regularly participates in a credit decision, including setting the terms of credit."¹⁴ Although indirect or third party auto lenders do not have face-to-face interactions with consumers during an auto finance transaction, the definition of creditor captures the lender's participation in setting the terms and conditions under which the dealerships offer loan products to consumers, loan products that include interest rate markups. While employees of the dealership determine the specific markup, the indirect or third party lender underwrites the loan, or sets the terms and conditions by which they will buy the loan, thereby establishing the parameters for the extension of credit. These terms and conditions may include the indirect lender's policy of allowing the dealerships to mark up their interest rate. In such an instance, the indirect lender is legally responsible if dealer markups have a discriminatory effect in violation of the ECOA.¹⁵

Supervisory and enforcement authority over auto finance is shared by a number of federal agencies. The CFPB has supervision authority over large banks (who provide indirect financing) and Buy Here Pay Here (BHPH) dealers.¹⁶ Non-bank auto lenders (including captive and independent finance companies) who meet the standards set forth in a "larger participant" rule also will be subject to CFPB's supervisory authority. In addition, the CFPB may supervise auto finance companies that are not larger participants if the Bureau has reasonable cause to determine that they are engaging or have engaged in conduct that poses risks to consumers under section 1024(a)(1)(C) of the Dodd-Frank Act. The CFPB may bring enforcement actions against large banks, BHPH

¹² 15 U.S.C. § 1691(a)(1).

¹³ 15 U.S.C. § 1691a(e).

¹⁴ 12 C.F.R. § 202.2(l).

¹⁵ See e.g. *United States v. Am. Future Sys., Inc.*, 571 F. Supp. 551, 560-61 (E.D. Pa. 1982), *aff'd*, 743 F.2d 169, 182 (3d Cir. 1984). The Department of Justice has brought actions against indirect auto lenders alleging that discretionary pricing policies violated the ECOA. See *United States v. Nara Bank, et al.*, No. 09-7124 (C.D. Cal. Sept 30, 2009).

¹⁶ A Buy Here Pay Here dealer is an automobile dealer or retailer who finances vehicle purchase contracts without assigning them to third parties.

dealers, and any nonbank auto finance company, regardless of whether the nonbanks are larger participants or subject to section 1024(a)(1)(C).

Auto dealers engaged in the sale or leasing of motor vehicles that regularly assign credit contracts to unaffiliated third parties are carved out of the CFPB's jurisdiction.¹⁷ Instead, the Federal Trade Commission (FTC) retains the authority to enforce ECOA and other consumer protection laws against these types of traditional franchise auto dealers – leaving them subject to no federal supervision.

Rulemaking authority also is shared by several federal agencies. The Federal Reserve Board has rulemaking authority for carved-out auto dealers under the ECOA and the other enumerated consumer financial laws. The FTC has authority to promulgate rules, pursuant to Section 5 of the FTC Act addressing unfair or deceptive acts or practices of carved-out auto dealers.¹⁸ CFPB has rulemaking authority over all “covered persons,” the definition of which exempts auto dealers.

Both the FTC and Federal Reserve Board have started to explore the possibility of rulemaking with respect to auto dealers. In 2011, the FTC hosted three public roundtables in Detroit, MI, San Antonio, TX, and Washington, DC to gather more information on consumer protection issues in connection with motor vehicle sales, financing, and leasing in order to assess the propriety of promulgating a rule or conducting other initiatives. In addition, the Federal Reserve Board plans to issue regulations governing auto dealers, to implement Dodd-Frank's requirement that creditors collect information about credit applications made by women or minority-owned businesses and by small businesses.

1.3. Current Bureau Efforts

1.3.1 Enforcement

The CFPB's Office of Enforcement has opened investigations into whether three subprime BHPH auto dealers have engaged in deceptive, unfair, abusive, or discriminatory practices, or other illegal conduct. BHPH dealers are distinct from typical used car dealers because BHPH dealers directly finance their sales and do not assign their loans to unaffiliated third parties.¹⁹ Instead, BHPH dealers typically keep the loans on their own books or transfer them to an affiliated finance company owned by the same franchise.

1.3.2 Fair Lending Supervision

The Bureau's 2012 large bank exam schedule includes several large bank indirect auto lenders during calendar year 2012. The Office of Fair Lending & Equal Opportunity, in conjunction with the Office of Research and the examination teams, will focus fair lending examinations of these lenders on dealer markups and discretion in underwriting. Fair Lending, Bank Supervision,

¹⁷ Dodd-Frank § 1029.

¹⁸ The FTC takes the position that it has authority to promulgate rules with respect to all auto dealers given the ambiguity of §§ 1029(a), (d).

¹⁹ Because of this financing structure, BHPH dealers generally are not subject to the carve-out in Dodd-Frank and therefore fall under the CFPB's jurisdiction. Dodd-Frank § 1029.

Research, and Installment & Liquidity Lending will collaborate on the development and roll out of auto finance fair lending examination protocols.

Non-bank auto lenders (including captive and independent finance companies) who meet the standards set forth in a “larger participant” rule also will be subject to CFPB’s supervisory authority.

1.3.3 Servicemember Affairs

Dodd-Frank requires that the Federal Reserve Board and the FTC coordinate with the Bureau’s Office of Servicemember Affairs to ensure that

1. Servicemembers and their families are educated and empowered to make better decisions regarding auto finance products and services, with a focus on dealerships that are near military installations; and
2. Complaints by service members and their families concerning dealerships are effectively monitored and responded to, and where appropriate, that enforcement action is pursued.

The Office of Servicemember Affairs has begun collecting reports of complaints by military personnel and their families against auto dealers and finance companies from JAGs and other service providers throughout the armed services. OFLEO has received anecdotal reports that some lenders use rank when pricing auto finance transactions. Because rank can correlate with race, gender and/or ethnicity, this raises the possibility of discriminatory auto finance practices with respect to servicemembers.²⁰

1.4 Need for “MCP” Process:

Discrimination in auto finance impacts several Bureau offices. Effective strategies for addressing this issue likely will require cross divisional resources and the use of multiple tools. The complexity of the regulatory scheme may present challenges and will require resources of various offices within the Bureau. As the auto finance discrimination initiative crosses the Bureau horizontally and impacts different interests, there is a need for a larger, strategic thought process to coordinate those efforts and ensure a consistent approach across the Agency. Moreover, because of the unique jurisdictional split between CFPB and other agencies, there will likely be a need for extensive interagency coordination.

2.0 Areas of Concern, Working Group Responsibilities, Composition, and Leadership

This working group proposes to study the areas of concern, investigate, draw conclusions, and make recommendations to the Policy Committee.

2.1 Areas of Concern

The Auto Finance Discrimination Working Group will develop a work plan that addresses the following areas:

²⁰ Letter from Undersecretary of Defense Clifford L. Stanley to Assistant Secretary for Financial Institutions Michael Barr (Feb. 26, 2010), available at http://carconsumers.org/military_ripoffs.htm.

- *Subjective Markup and High Margin Additional Products.* Evaluate the scope of dealer markups and add-ons in the auto finance industry and quantify the harm to consumers. This includes analyzing whether caps on dealer markups still exist and whether the presence of such caps reduces or eliminates the risk of discrimination. The Working Group may host an industry roundtable as part of these information-gathering efforts.
- *Supervision of Indirect Auto Lenders.* Review and assess data and information gathered in the course of 2012 examinations of indirect auto lenders for evidence of discriminatory practices.
- *Transparency/Consumer Education.* Evaluate consumer complaint trends and research/evaluate the scope of consumers' knowledge about auto financing. Develop a consumer education tool to equip consumers with information about the auto financing process.
- *Discriminatory Practices -- Military Issues.* Gather information regarding the use of rank and other factors that may have a disparate impact on protected classes within the military.
- *Enforcement Investigation of Buy Here Pay Here Dealers.* Review and assess data collected in the course of Enforcement's investigation of larger BHPH dealers to determine whether there may be fair lending violations.
- Identify additional actions the CFPB should take in the area of auto finance to prevent and remedy unlawful discrimination.

2.2 Responsibilities

The Auto Finance Discrimination Working Group ("Working Group") will be responsible for analyzing the Areas of Concern listed in section 2.1 above, specifically: evaluating the risks to consumers, analyzing evidence and data, considering the legal and regulatory context, and making recommendations for actions to the Policy Committee with respect to discrimination in auto finance.

2.3 Composition:

The Working Group will include representatives from the Offices of Fair Lending, Installment and Liquidity Lending Markets, Servicemember Affairs, Research, Enforcement, General Counsel, Financial Education, and Supervision (Bank and Nonbank).

2.4 Leadership:

The Working Group will be co-chaired by Katherine Gillespie and Katie Worthman (OFLEO). The Steering Committee will oversee the Working Group's progress, review and comment on its findings, and approve (possibly with amendments) the Working Group's final recommendations to the Policy Committee. The Steering Committee will consist of leadership from CEE, RMR, External Affairs, OGC, and SEFL, and will be chaired by Patrice Ficklin.

2.5 Timing:

The Auto Finance Discrimination Working Group will submit a work plan to the Policy Committee within three weeks of approval of this Charter. The work plan will outline the various ways in which the Working Group will study the Areas of Concern listed above, including milestones and deliverables.

By September 27, 2012, the Working Group will prepare an options memorandum for the Policy Committee that evaluates the scope and extent of potential discrimination involving protected classes in the auto finance market and makes recommendations for coordination across the Bureau to address those issues.

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From: Patrice Ficklin, Office of Fair Lending & Equal Opportunity
Richard Hackett, Office of Installment and Liquidity Lending

Recommendation:

That you approve the attached Charter for an Auto Finance Discrimination Working Group.

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Background:

The Bureau set its priorities for the first two years through the Workstream A process. Discrimination in auto finance was one of the priorities chosen through that process. The Office of Fair Lending & Equal Opportunity has worked with the Office of Installment & Liquidity Lending Markets and other colleagues at the Bureau to draft the attached Charter that proposes the establishment of an Auto Finance Discrimination Working Group. As explained in detail in the attached Charter, the proposed Working Group will lead the Bureau's efforts to study, investigate, and make recommendations about particular areas of concern in the auto finance market, including subjective markups of interest rates, financing of high margin additional products, and Buy Here Pay Here dealers. The Auto Finance Discrimination Working Group's work will be completed on September 27, 2012 with an options memorandum presented to the Policy Committee. The attached Charter was cleared by the directorates of Fair Lending and RMR and was presented to and cleared by the Policy Committee on February 9, 2012.

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1.0 Background, Legal Context and Current CFPB Efforts

1.1 Background

After mortgage and home equity loans, auto finance debt is the second largest category of consumer debt in originations in the United States. An estimated 36 million consumers take on approximately \$350 billion in new auto finance debt every year.¹ With the average price of a new automobile exceeding \$29,000, and used cars ranging from \$8,875 to \$16,474 at dealerships², a car purchase or lease is the most expensive financial transaction engaged in by most consumers.

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