PRIVILEGED AND CONFIDENTIAL

1700 G Street NW, Washington, DC 20552

October 17, 2013

DECISION MEMORANDUM FOR THE DIRECTOR

FROM: Melissa Baal Guidorizzi, Ori Lev, Kent Markus, and Tony Alexis, Office of Enforcement

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Charles Nier, Rebecca Gelfond, and Patrice Ficklin, Office of Fair Lending

SUBJECT: Authorization to Seek a Settlement with Ally Financial, Inc. and Ally Bank and to File Complaint and Resolution in Federal District Court or to File a Resolution Administratively.

RECOMMENDATION:

That you approve (1) settlement negotiations with Ally, within the parameters set forth at Section VI.D of this memorandum, (2) the filing of a complaint and consent order in federal court or a stipulation and consent administratively effectuating such a settlement if those settlement negotiations are successful; and (3) proceeding with an investigation of the practices discussed in this memorandum in the event of unsuccessful settlement negotiations. We are also simultaneously recommending that the Bureau refer this matter to the DOJ, which, depending on the timing of any potential settlement, may choose to join our efforts.

JRC

__✓__ Approve ______ Disapprove ______ Discuss

I. EXECUTIVE SUMMARY

The Office of Enforcement and the Office of Fair Lending and Equal Opportunity ("staff") seek authority to settle with Ally Financial, Inc. ("AFI") and Ally Bank ("AB") (collectively "Ally")[1] for alleged violations of the Equal Credit Opportunity Act ("ECOA"), 15 U.S.C. §§ 1691-1691f, and its implementing regulation, Regulation B, 12 C.F.R. pt. 1002. Staff has concluded that from April 1, 2011 through March 31, 2012, Ally violated the ECOA by charging African-American, Hispanic, and Asian borrowers higher interest rates through higher dealer markups on their automobile loans than similarly situated non-Hispanic white borrowers on the basis of race and national origin. These disparities resulted from a combination of Ally's policy and practice of permitting dealers to

[1] Both AFI and AB hold indirect consumer automobile loans, and systems and processes are the same for both. The primary difference between the portfolios is that AFI holds lower credit quality paper.

mark up interest rates on retail installment contracts, compensating dealers from the interest revenue from those markups, and its failure to implement or maintain adequate internal controls and monitoring to prevent the discrimination from occurring.

Statistical analyses conducted by the Office of Research establish the following disparities during the time period from April 1, 2011, to March 31, 2012:

- African Americans paid an average of 28.9 basis points higher for non-subvented loans and 22 basis points higher for subvented loans,[2] than similarly situated non-Hispanic white borrowers;
- Hispanics paid an average of 19.6 basis points higher for non-subvented loans and 14.3 basis points higher for subvented loans, than similarly situated non-Hispanic white borrowers; and
- Asians paid an average of 21.5 basis points higher for non-subvented loans, than similarly situated non-Hispanic white borrowers.

On average, these disparities are expected to cost over 213,000 consumers $192 each over the full life of the loan, totaling over $41 million in possible direct damages resulting from the conduct during the time period from April 1, 2011, to March 31, 2012.

Past cases have demonstrated that pricing disparities that result from granting automobile dealers discretion to mark up interest rates can provide the basis for actionable claims of discrimination in violation of the ECOA.[3] This is the first case the Bureau seeks to settle that alleges violations of the ECOA for discriminatory dealer markup in the indirect automobile lending industry. As such, it will send an important message to the indirect auto lending industry about the Bureau's commitment to ensuring compliance with the ECOA.

The final settlement value of this matter will vary based on the strength of several defenses that Ally will likely raise; these are discussed more below. Overall, we request authority to settle this matter in the range of $34 to $204 million. As discussed more fully below, that range consists of the following:

(1) direct damages in the range of $10 million to $41 million (paid as money or as a note rate reduction), representing overpayment based on race and/or national origin over the full life of the loans originated during the exam period from April 1, 2011 to March 31 2012;

(2) a fund for direct damages identified through an agreed-upon method estimated to be in the range of $14 million to $57 million (paid as money or as a note rate reduction), which will be set aside to address overpayment based on race and/or national origin over the full life of the loan for consumers who may have been subject to discriminatory markups during the time period from April 1, 2012, to the present;

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[2] A subvented loan is a loan with special pricing due to financing subsidies provided by the automobile manufacturer.

[3] *See Jones v. Ford Motor Credit Co.*, 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002) (denying a motion to dismiss); *Osborne v. Bank of America Nat'l Ass'n.*, 234 F. Supp. 2d 804 (M.D. Tenn. 2002) (denying motion to dismiss); *Wise* ex rel *Estate of Wilson v. Union Acceptance Corp.*, 2002 WL 31730920 (S.D. Ind. Nov. 19, 2002) (denying motion to dismiss); *Coleman v. General Motors Acceptance Corp.*, 220 F.R.D. 64 (M.D. Tenn. 2004) (granting class certification).

(3) indirect damages grounded in emotional distress in the amount of $0 to $32 million for the exam period from April 1, 2011, to March 31, 2012, and $0 to $44 million for the time period from April 1, 2012 to the present;

(4) civil money penalties in the range of $10 million to $30 million; and

We also seek authority to negotiate, in our discretion, for injunctive relief requiring Ally to adopt an alternative compensation structure and/or enhancements to its dealer markup monitoring compliance program.

II. BACKGROUND

A. Proposed Defendant: Ally

Ally is one of the largest auto loan lenders in the United States.[4] In 2012, Ally originated automobile loans, reflecting in loan volume. As of December 31, 2012, Ally's domestic consumer automobile portfolio totaled approximately . Ally's consumer automobile finance business is 100% indirect lending. Ally purchases loans from a network of over .

Ally is in the end stages of a major reorganization that will effectively end its participation in the mortgage market and that will eliminate its international automotive business. This is being done to limit liability from the mortgage business and to improve capitalization and the balance sheet so that Ally can proceed with an IPO to raise capital to pay off the U.S. Treasury's TARP investment, which represents a 74% ownership in the company.

A related issue to the reorganization is AFI's need to convert to a financial holding company to retain certain businesses, most important of which is its insurance business (primarily service contracts, maintenance agreements, gap insurance, and commercial insurance for dealers). According to its 2012 10-K, Ally noted that upon its bank holding company approval on December 24, 2008, it was permitted an initial two-year grace period to bring its activities and investments into conformity with the BHC Act restrictions. The grace period expired in December 2010. The FRB then granted two one-year extensions that expired in December 2012 and recently granted a third one-year extension that expires in December 2013. According to its 2012 10-K, Ally will not be permitted to apply to the FRB for any further extensions. Ally's existing activities and investments deemed impermissible under the BHC Act will need to be terminated or disposed of by December 2013 unless Ally is able to convert to a financial holding company under the BHC Act prior to that time, the most significant of which includes most of Ally's insurance activities and its SmartAuction vehicle remarketing services for third parties. This could have a material adverse effect on Ally's business, results of operations, and financial position.

[4] Based on 2011 Experian data.

B. Ally's Relevant Markup Policies

Ally purchases loans from its dealers at a specified "buy rate," which Ally determines using a proprietary underwriting and pricing model. Ally will, however, purchase installment contracts that the dealer, in its discretion, has priced higher than the buy rate, subject to certain limitations. The difference between the buy rate and the contract rate is known as the dealer markup. Ally limits the markup to [REDACTED] basis points for contracts with terms of [REDACTED] years or less and [REDACTED] basis points for contracts with terms of greater than [REDACTED] years. Ally then compensates the dealers from the increased interest revenue from the markup. As discussed more below, Ally's discretionary markup and compensation policy and its lack of monitoring and controls caused the pricing disparities discovered during the review.

C. Investigation History and Background

In 2010, the Federal Reserve Bank of Chicago conducted a targeted examination of Ally's consumer compliance program. On July 19, 2010, the Federal Reserve Bank issued a report that included a Matter Requiring Attention (MRA) instructing Ally to implement a comprehensive fair lending monitoring and testing program for consumer automotive lending. Also, in 2010, the FDIC commenced an examination of Ally that included a review of its consumer automotive lending. While the FDIC did not find discrimination, in July 2011 the FDIC briefed the Bureau on its preliminary findings of pricing and underwriting disparities in loans to Hispanic borrowers, in anticipation of the transfer of ECOA jurisdiction to the CFPB.

On September 10, 2012, the Bureau commenced a targeted review of Ally to test for fair lending compliance in its domestic consumer automobile finance portfolios. The review covered transactions from April 1, 2011 to March 31, 2012. During the period of review, Ally booked [REDACTED] loans and the Office of Research considered [REDACTED] of those transactions for analysis. These transactions involved [REDACTED] unique dealers with [REDACTED] dealers accounting for [REDACTED] of the volume by amount financed. The Office of Research conducted statistical analyses and identified the above-mentioned dealer markup disparities.[5]

The Office of Fair Lending formally communicated its preliminary findings to Ally by sending a Fair Lending Potential Action and Request for Response Letter on January 15, 2013 (the "PARR letter"). The PARR letter stated the disparity amounts and outlined the Bureau's analytical methodology. It also informed Ally of the possibilities of public enforcement action and DOJ referral. On February 11, 2013, Ally submitted a written response to the PARR letter, in which Ally contends that it has not violated ECOA and that if ECOA violations are determined, formal enforcement is an inappropriate remedy. The PARR and Ally's response are attached to this memorandum.

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[5] In addition to dealer markup, the Office of Research performed a scoping evaluation of underwriting exceptions and other potential pricing disparities across race, ethnicity, and sex, including buy rates (lender's interest rate quoted to dealers), rate shaves (discretionary downward adjustments made by Ally to the buy rate), and tier bumps (discretionary adjustments made by Ally to its proprietary credit scoring system to lower the buy rate) and did not identify any material disparities.

III. VIOLATIONS OF THE ECOA AND REGULATION B

The ECOA and Regulation B prohibit discrimination on the basis of, *inter alia*, race and national origin in "any aspect of a credit transaction."[6] A violation of the ECOA may be proven through (i) overt evidence of discrimination, (ii) evidence of disparate treatment, or (iii) evidence of disparate impact.[7] While disparate treatment may be a possible method to establish an ECOA violation in a discriminatory dealer markup matter, staff believes that, based on current information, the strongest case to prove Ally's violation of the ECOA can be made under the disparate impact theory.[8]

Regulation B, which implements the ECOA, specifies that the disparate impact doctrine is applicable under the ECOA. Specifically, Regulation B states that "[t]he legislative history of the Act indicates that the Congress intended an 'effects test' concept, as outlined in the employment field by the Supreme Court in the cases of *Griggs v. Duke Power Co.,* 401 U.S. 424 (1971), and *Albermarle Paper Co., v. Moody,* 422 U.S. 405 (1975), to be applicable to a creditor's determination of creditworthiness."[9]

As set forth in Regulation B, the ECOA prohibits a "creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact."[10] Thus, to demonstrate a prima facie case of disparate impact liability, the Bureau must: (1) identify a specific facially neutral practice or policy used by the defendant; and (2) demonstrate, through statistical evidence, that the practice or

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[6] 15 U.S.C. § 1691(a)(1); 12 C.F.R. § 1002.4(a).

[7] *See* CFPB Bulletin 2012-04, *Lending Discrimination* (Apr. 18, 2012), available at http://files.consumerfinance.gov/f/201404_cfpb_bulletin_lending_discrimination.pdf.

[8] A claim of discrimination under the disparate treatment doctrine may also be available. An inference of discriminatory intent may be shown through statistical evidence of a pattern or practice of racial discrimination. *See Int'l Brotherhood of Teamsters v. U.S.,* 431 U.S. 324, 339-40 & n. 20 (1977); *Hazelwood Sch. Dist. v. United States,* 433 U.S. 299, 307–08 (1977)(gross statistical disparities may, in a proper case, constitute prima facie proof of a pattern or practice of disparate treatment). *But see Gay v. Waiters' and Dairy Lunchmen's Union, Local No. 30,* 694 F.2d 531, 552 (9th Cir. 1982) ("In order to establish a prima facie case of disparate treatment based solely on statistical evidence, the plaintiff must produce statistics showing 'a clear pattern, unexplainable on grounds other than race.'") (internal citations omitted). However, courts have cautioned that the strongest inference of intentional discrimination is one in which the statistical evidence is bolstered by other circumstantial evidence because "statistics demonstrating that chance is not the more likely explanation are *not* by themselves sufficient to demonstrate that race *is* the more likely explanation . . .." *Gay,* 694 F.2d at 553 (citations omitted). Once a prima facie case is established, the burden shifts to the defendant to provide a legitimate nondiscriminatory reason for its different treatment. *See McDonnell,* 411 U.S. at 802. Finally, the plaintiff then may prove that the legitimate nondiscriminatory reason provided by defendant is a pretext for discrimination. *Id.* at 804. At this point in the investigation, the evidence of discrimination on the basis of race and national origin is strictly statistical. However, staff believes that the evidence is arguably sufficient to establish a prima facie case of disparate treatment. While staff does not anticipate negotiating a settlement with defendants that expressly identifies the different available theories of discrimination under the ECOA, staff raises it in this memorandum to provide an outline of all available legal theories of liability under the ECOA.

[9] 12 C.F.R. § 1002.6(a).

[10] 12 C.F.R. pt. 1002 Supp. I § 1002.6(a)-(2).

policy has caused an adverse effect on the protected group.[11] The burden then shifts to the defendant to prove a legitimate business need for the practice or policy.[12] But the plaintiff can still prevail if there is a less discriminatory alternative that meets the business need.[13] The Bureau recently affirmed that in enforcing ECOA, it will utilize as appropriate the disparate impact doctrine.[14]

A. *Ally Employed a Specific, Facially Neutral Policy That Has a Disparate Impact: The Discretionary Dealer Markup and Compensation Policy with Insufficient Monitoring*

1. Discretionary Pricing Policy

As described above, Ally maintains a specific policy and practice that provides dealers discretion to mark up consumers' interest rate above Ally's established buy rate, and compensates dealers for those markups. Pointing to the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011), Ally asserts in its PARR response that its policy and practice is not a "specific policy or practice" recognized under the law as a predicate for claims under ECOA because it is a "decades-old industrywide business model engrained in the fabric of commercial law."[15] The Supreme Court in *Dukes* held that the Fed. R. Civ. P. 23(a)(2) class action certification prong of "commonality" was not met because respondents could not provide convincing proof of a company-wide discriminatory pay and promotion policy. Of course, a government enforcement action for violations of the ECOA need not meet Rule 23(a)'s class certification requirements, but there is language in the *Dukes* opinion that Ally would likely rely upon if this matter were to be litigated.[16]

We believe there are compelling grounds to distinguish *Dukes*, which was decided in a different procedural and factual context.[17] *Dukes* did not purport to overrule existing precedent

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[11] *See Albermarle Paper Co. v. Moody*, 422 U.S. 405, 425 (1975); *Griggs v. Duke Power Co.*, 401 U.S. 424, 431-32 (1971).

[12] *See Griggs*, 401 U.S. at 431-32.

[13] *See Albermarle*, 422 U.S. at 425.

[14] *See* CFPB Bulletin 2012-04 (Fair Lending) (Apr. 18, 2012).

[15] Ally PARR Response, p. 8.

[16] *See Dukes*, 131 S.Ct. at 2555 ("In the landmark case of ours which held that giving discretion to lower-level supervisors can be the basis of Title VII liability under a disparate-impact theory, the plurality opinion *conditioned* that holding on the corollary that merely proving that the discretionary system has produced a racial or sexual disparity *is not enough*.... Other than the bare existence of delegated discretion, respondents have identified no 'specific employment practice'.... Merely showing that Wal-Mart's policy of discretion has produced an overall sex-based disparity does not suffice.") (emphasis in original); *see also In re Countrywide Fin. Corp. Mortg. Lending Practices Litig.*, 708 F.3d 704, 708 (6th Cir. 2013) ("Both Wal-Mart and Countrywide placed clear boundaries on how far a local exercise of discretion could go, but in neither case do plaintiffs demonstrate that this range, rather than discretionary decisions made within this range, disparately impacted the proposed class. On this point, Dukes is clear: class members must unite acts of discretion under a single policy or practice, or through a single mode of exercising discretion, and the mere presence of a range within which acts of discretion take place will not suffice to establish commonality.").

[17] At least one court has refused to apply *Dukes* in a government enforcement action, noting that *Dukes'* holding is limited to class certification. In *Illinois v. Wells Fargo & Co.*, No. 09-26434 (Ill. Cir. Ct. Cook County Oct. 25, 2011), the Illinois Attorney General sued Wells Fargo under various state laws including the Illinois Human Rights Act, alleging that Wells Fargo engaged in illegal discrimination through reverse redlining and by steering minorities into more expensive loans than similarly situated White borrowers. In denying a motion to dismiss the disparate impact

regarding disparate impact liability,[18] and prior to *Dukes* a number of courts specifically held that dealer markup policies similar to Ally's constitute a "specific policy or practice" sufficient to establish a prima facie case under disparate impact analysis.[19] For example, in *Coleman v. General Motors Acceptance Corp.,* the court, relying upon the Supreme Court's holding in *Watson v. Fort Worth Bank and Trust,* 487 U.S. 977, 994 (1988), held that the use of disparate impact was appropriate where the lender's policy "is race neutral (or objective) by its terms," but "[w]hen exercised by those granted discretion under the neutral policy, its effect is to discriminate." *Coleman,* 196 F.R.D. 315, 328 (M.D. Tenn. 2000), *vacated and remanded on unrelated grounds,* 296 F.3d 443 (6th Cir. 2002). Thus, we believe we have a strong argument that Ally maintains a specific facially neutral policy sufficient to establish an ECOA claim under the disparate impact doctrine.

2. Fair Lending Policies and Insufficient Monitoring

Despite previous regulatory instruction to implement a comprehensive fair lending monitoring and testing program for consumer automotive lending, most notably in the July 19, 2010, targeted examination report of consumer compliance issued by the Federal Reserve Bank of Chicago, Ally did not have a comprehensive fair lending monitoring and testing program for consumer auto finance at the time the Bureau's review commenced. Although during the early stages of the review, Ally indicated that a monitoring and testing program was under development, the company did not initially reveal the program, other than a brief outline to examiners, based on a claim of attorney-client privilege.

Finally, during a meeting on March 21, 2013, Ally discussed with the CFPB its consumer automotive fair lending program and shared a document entitled *Pilot Monitoring Program for Dealer Finance Income* the following day. While management's efforts to design and implement a program are acknowledged, the discussions and a review of the document indicate that substantial work remains to develop and implement an effective program. We have a number of concerns and issues with Ally's proposed dealer monitoring program, including its limitations on the prohibited-basis groups covered by the plan; flaws in the method for estimating disparities; excessive threshold for follow-up inquiry; prerequisites of two consecutive disparity findings to take further action; the inclusion of a flawed comparative file review that dilutes any statistical disparities; prolonged timeframes for dealer corrective action; its dealer-level as opposed to portfolio-level focus; and its exclusion of any consumer remediation.

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claims, the court found that *Dukes* did not apply, stating that "the pertinent issue [in *Dukes*] was whether the plaintiff demonstrated questions of law and fact common to the class, an issue not pending before this Court." *Id.* at 9 n.1 (citations omitted). Furthermore, DOJ has filed and settled a number of other complaints alleging unlawful pricing discretion since *Dukes. See, e.g.,* Consent Order, *United States v. SunTrust Mortg., Inc.,* No. 3:12-cv-397 (E.D. Va. May, 31, 2012), available at *http://www.justice.gov/iso/opa/resources/31320125311625383042O.pdf*; Consent Order, *United States v. Countrywide Fin. Corp.,* No. CV11-10540-PSG (AGW) (C.D. Cal. Dec. 28, 2011), available at *http:// www.justice.gov/crt/about/hce/documents/countrywidesettle.pdf;* Consent Order, *United States v. GFI Mortg. Bankers, Inc.,* No. 12-cv-2502-KBF (S.D.N.Y. Aug. 27, 2012), available at *http://www.justice.gov/crt/about/hce/documents/gfisettle.pdf.*

[18] *See Talbor v. Hilti, Inc.,* 703 F.3d 1206, 1221-22 (10th Cir. 2013).

[19] *Jones v. Ford Motor Credit Co.,* 2002 WL 88431 (S.D.N.Y. Jan. 22, 2002); *Osborne v. Bank of America Nat. 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); *Coleman v. General Motors Acceptance Corp.,* 220 F.R.D. 64 (M.D. Tenn. 2004).

Subsequently, Ally's analysis pursuant to the program resulted in the identification of only 21 dealers out of approximately 12,000 for possible markup disparities. The follow-up comparative file review analysis for each of the 21 dealers resulted in the identification of, only two low-volume dealers as having possible markup disparities and Ally imposed the limited first tier corrective action of voluntary education. Such results demonstrate that Ally's program is inadequate to address large portfolio-wide disparities.

Overall, Ally's program does not satisfactorily identify and respond to potential dealer markup disparities and therefore is inadequate to mitigate fair lending risk. Additionally, Ally lacked any monitoring or controls for fair lending risk in its consumer automotive lending until it operationalized its *Pilot Monitoring Program* in March 2013.

B. Ally's Practices and Policies Caused a Statistically Significant Adverse Effect on Similarly-Situated African Americans, Hispanics, and Asians

In establishing disparate impact liability, courts have long recognized that statistics, when properly analyzed, can support a showing of disparate impact on a protected class.[20] In the context of dealer markup policies, courts have held that a plaintiff, for purposes of establishing a prima facie case, must provide "'statistical evidence of a kind and degree sufficient to show that the practice in question has caused' the assessment of the higher finance charge markup because of their membership in a protected group."[21] In this case, the statistical analysis that the Office of Research conducted shows that Ally's discretionary markup and compensation policy, without meaningful controls and monitoring, disproportionately and adversely affected similarly-situated African-American, Hispanic, and Asian consumers. The Office of Research's conclusion was based on a comprehensive two-part statistical analysis that included over 1 million Ally loans.

In conducting the analysis, the Office of Research first had to assign race and national origin probabilities to each application.[22] Reported addresses for applicants were mapped into census tracts and matched to 2010 Census information on race and ethnicity. Surnames were matched to a list of surnames from the 2000 Census, which reports counts of individuals by race and ethnicity for surnames. Using the combination of proxies based on geography and surname, the methodology assigned an applicant with a probability of being a particular race or ethnicity (*e.g.*, 80% African American; 15% Hispanic; and 5% non-Hispanic White).

The Office of Research then conducted an analysis of whether Ally's policy of permitting automobile financing markup resulted in disparities. The auto loan data set provided to the CFPB contained [redacted] auto loan contracts that were funded by Ally between April of 2011 and

[20] *See generally Int'l Brotherhood of Teamsters v. U.S.*, 431 U.S. 324, 340 n. 20 (1977) (noting that statistics may be the "only available avenue of proof" in disparate impact cases) (citations and internal quotation marks omitted).

[21] *Coleman*, 196 F.R.D. at 324, quoting *Watson v. Fort Worth Bank and Trust*, 487 U.S. 977, 994 (1988).

[22] Section 1002.5(b) of Regulation B generally prohibits lenders from requesting information about the applicant's race and national origin for credit transactions that are not for the purpose of purchase or refinancing the borrower's principal dwelling and secured by that dwelling. Consistent with this rule, the indirect auto loan dataset provided by Ally did not contain information on the applicants' race or ethnicity. In order to conduct the statistical analyses, the Office of Research used a proxy methodology for assigning race and ethnicity to applicants based on reported address information and name.

March of 2012. Prior to analysis, booked contracts with missing credit tier, missing automobile make, contracts for recreational vehicles (RVs), missing automobile type, and contracts for which a geography or name based proxy could not be assigned were excluded from the analysis.[23] In total, [redacted] book loans were included in the analysis sample.

Given the fact that Ally's buy rate on any given transaction is determined by a variety of characteristics associated with the individual financing the car, characteristics of the vehicle, and the timing, location, and structure of the deal, such factors were excluded as controls from the markup analysis, which focused on the uncontrolled *difference* between the contract rate and the buy rate, rather than on the contract rate. Furthermore, the Office of Research conducted a separate analysis of subvented loans given the fact that special financing with specific program caps is applicable in such programs. The analysis with no controls resulted in the following observations with respect to disparities and consumer impact based upon expected overpayment over the full life of the loan:

- African Americans paid an average of 28.9 basis points higher for non-subvented loans and 22 basis points higher for subvented loans, than similarly situated non-Hispanic white borrowers;
- Hispanics paid an average of 19.6 basis points higher for non-subvented loans and 14.3 basis points higher for subvented loans, than similarly situated non-Hispanic white borrowers; and
- Asians paid an average of 21.5 basis points higher for non-subvented loans, than similarly situated non-Hispanic white borrowers. *See* Table 1.

Table 1:

Ally Financial/Ally Bank - Observed Disparities and Consumer Impact

Period of Study: April 1, 2011 to March 31, 2012

Prohibited basis	Subvention/non-subvention	# pb observations	Estimated disparity in mark-up	Est. value of overpayment	Overpayment per borrower
Asian/Pacific Islander	Non-subvention	9,139	0.215	$1,469,073	$160.75
Black	Non-subvention	93,687	0.289	$21,709,581	$231.72
Hispanic	Non-subvention	82,744	0.196	$13,361,785	$161.48
Black	Subvention	15,130	0.220	$2,899,239	$191.62
Hispanic	Subvention	12,835	0.143	$1,628,417	$126.87
Total Adverse Impact		213,535		$41,068,095	$192.32

[23] In total, 145,773 contracts were excluded from the analysis, including: 5,906 RV contracts, 21 contracts for missing tier, 11 contracts for missing vehicle make, 187 contracts for missing vehicle type, 121,897 contracts due to no race or ethnicity proxy, and 17,751 contracts due to no sex proxy. The inability to assign a race or ethnicity proxy to some contracts is attributable to the fact that some legitimate last names are not found on the Census surname list, which only reports names occurring 100 times and some applications in the Ally data may be made in the name of a business (there is no indicator in the data for business loans). Likewise, the inability to assign a sex proxy to some contracts is attributable to that fact some legitimate first names are not found on the Social Security Administration's list, which are only reported if the first name occurs 5 times for a given sex, and some applications in the Ally data may be made in the name of a business (there is no indicator in the data for business loans).

These disparities are statistically significant at the 5 percent level or better, well within what the courts require.[24] Such significant statistical evidence is of a kind and degree sufficient to show that the Ally's dealer mark-up policy and practice has caused disparities based upon race and national origin.

In order to evaluate the robustness of the results, the Office of Research controlled for maximum amount of markup because the cap depends on loan term and, for borrowers assigned to the two lowest credit tiers, Ally's proprietary credit-tier assignment. Even when the Office of Research considered such factors, the disparities remained substantial. In addition, the Office of Research generated disparity estimates using alternative methods of assigning race and ethnicity. First, the Office of Research used threshold rules that assigned an application to a given racial or ethnic group by determining whether the probability associated with each classification meets or exceeds one of the three thresholds (70%, 80%, and 90%).[25] The disparity did not vary materially when the models used race and ethnicity assignments based on the threshold rules instead of the probabilities directly. Second, the Office of Research estimated disparities using geography and surname-based probabilities alone rather than jointly; the disparity estimates were consistent with those associated with the use of the joint probabilities.[26]

C. The Legitimate Business Need Defense

Once the Bureau has identified a specific facially neutral practice or policy used by the defendant, and demonstrated through statistical evidence that the practice or policy has caused an adverse effect on the protected group, as outlined above, the burden then shifts to the defendant to prove a legitimate business need for the practice or policy.

Ally has asserted that its business model has a legitimate business purpose. In Ally's response to the PARR letter, it stated that it cannot unilaterally reduce the rate spread limitations without substantial risk to its business. Ally notes that attempts to do so will result in dealers simply offering their contracts to Ally's competitors.

While discretionary pricing may be a legitimate industry practice standing alone, when it results in pricing that is disproportionately imposed upon protected group borrowers, such disparities cannot be justified solely by pointing to other lenders engaged in a similar potentially discriminatory policy. Moreover, Ally's argument was explicitly rejected in *Smith v. Chrysler Financial Co., L.L.C.*, 2003 WL 328719, at *7 (D.N.J. Jan. 15, 2003), in which the court rejected defendant's argument "that their actions are not improper because they are simply following a

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[24] *See generally* David H. Kaye & David A. Freedman, *Reference Guide on Statistics, in Annotated Reference Manual on Scientific Evidence*, 83, IV.B.2 (Fed. Judicial Ctr. Ed., 2d ed. 2000), available at 2004 WL 48151. *Cf. FTC v. QT, Inc.*, 448 F.Supp.2d 908, 939 (N.D. Ill. 2006), *aff'd*, 512 F.3d 858 (7th Cir. 2008) ("Statistical significance is achieved if the statistical analysis shows that there is a 0.05 or less likelihood that the difference measured is due to chance (p $\leq$0.05).").

[25] *See generally* McCaffrey and Elliott, "Power of Tests for a Dichotomous Independent Variable Measured with Error," *Health Research and Educational Trust*, June 2008.

[26] For example, in some instances, the disparities were higher and in others lower. Limiting the proxy to only geography, significantly reduces the expected accuracy of the proxy with respect to Asians and Hispanics, but nonetheless produced results that did not contradict the combined methodology.

recognized business practice within the financial industry," noting that "[t]hese arguments are not compelling because the law does not allow subjective mark-up policies that result in discrimination against a protected class absent a valid business justification."

D. Less Discriminatory Alternative: Alternative Dealer Compensation Structure or Effective Monitoring, Controls, and Training

In the event that a defendant is able to prove a legitimate business need for the practice or policy, the plaintiff can still prevail if there is a less discriminatory alternative that meets the business need.[27] In this matter, even if Ally could identify a legitimate business need for the discretionary dealer markup policy, less discriminatory alternatives are available. For example, a markup policy with appropriate monitoring, controls, training, and consumer remuneration is a less discriminatory alternative. Nothing precluded Ally from employing monitoring and controls during the relevant period. And while Ally has sought to implement a monitoring policy, controls, and training efforts, its program does not satisfactorily identify potential dealer markup disparities and does not adequately mitigate fair lending risk. As a result, Ally failed to institute a discretionary pricing policy with sufficiently effective monitoring, controls, training, and consumer remuneration nor does it have any apparent intentions of instituting non-discretionary dealer compensation structure.

IV. ANTICIPATED ARGUMENTS FROM ALLY

A. Disparate Impact Claims under the ECOA

In 2005, the Supreme Court held that the Age Discrimination in Employment Act, 29 U.S.C. § 621 *et seq.* ("ADEA"), permitted disparate impact claims by comparing language in the ADEA to analogous language in Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e *et seq.* ("Title VII"). Specifically, the Supreme Court in *Smith v. City of Jackson, 544 U.S. 228 (2005)* held that both Title VII and the ADEA contain language prohibiting actions that "deprive any individual of employment opportunities or *otherwise adversely affect* his status as an employee."[28] Although *Smith* is not an ECOA case, Ally has argued in its PARR letter that the ECOA does not have the statutory language cited in *Smith* and thus that disparate impact claims are not available under the ECOA.

No court has applied *Smith* to find that disparate impact claims are not cognizable under the ECOA.[29] To the contrary, courts have consistently held that *Smith* did not impose a requirement that the exact language in Title VII or the ADEA must be present for a disparate impact claim to be cognizable under other statutes, including the ECOA.[30] Moreover, the

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[27] *See Albermarle,* 422 U.S. at 425.

[28] *Smith* , 544 U.S. at 235 (emphasis in original).

[29] *See Guerra v. GMAC LLC,* No. 2:08-cv-01297, 2009 WL 449153, at *2 (E.D. Pa. Feb. 20, 2009).

[30] See *Taylor v. Accredited Home Lenders, Inc.*, 580 F. Supp. 2d 1062, 1067 (S.D. Cal. 2008) ("There are no court decisions finding the ECOA and the FHA do not permit disparate impact actions in light of *Smith*. In fact, there are numerous decisions recognizing disparate impact claims under the statutes following the decision issued in *Smith. See Budnick v. Town of Carefree*, 518 F.3d 1109 (9th Cir. 2008) (Providing elements necessary to establish a prima facie case of disparate impact under the FHA); *National Community Reinvestment Coalition v. Accredited Home Lenders Holding Co.*, 573 F.Supp.2d 70 (D.D.C. 2008) (Finding *Smith* does not preclude disparate impact claims under the FHA);

availability of disparate impact liability under the ECOA is supported by its governing regulation, ECOA's legislative history, and all other federal regulatory and enforcement agencies with ECOA jurisdiction. Regulation B specifically incorporates the disparate impact doctrine under the ECOA.[31] The ECOA's legislative history explicitly states that the ECOA was intended to include disparate impact liability.[32] Finally, as set forth in the Interagency Policy Statement on Discrimination in Lending,[33] federal regulators have consistently recognized disparate impact liability under the ECOA.

Of course, the Supreme Court has granted certiorari in *Township of Mount Holly. v. Mount Holly Gardens Citizens in Action, Inc.*, 658 F.3d 375 (3d Cir. 2012), *cert. granted*, 133 S. Ct. 2824 (June 17, 2013), to determine whether disparate impact liability exists under the Fair Housing Act. Although *Mt. Holly* may embolden Ally to contend that disparate impact liability under the ECOA does not exist, any ruling stemming from that decision would be limited to the FHA. Furthermore, the argument in support of the availability of disparate impact claims under ECOA is different than under the FHA given the specific language of ECOA, the and long-standing language in Regulation B, the supporting legislative history, and the positive case law.

B. Liability of Indirect Auto Lenders

Ally argued in its PARR response that it is not liable under the ECOA because it did not regularly "participate" in the credit decision or because it is an assignee with no knowledge of allegedly discriminatory actions taken by the dealers who originated the loans.

The ECOA defines a "creditor" to include not only "any person who regularly extends, renews or continues credit," but also "any assignee of an original creditor who participates in the

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Ramirez v. GreenPoint Mortg. Funding, Inc., 2008 WL 2051018 (N.D.Cal. 2008) (Finding disparate impact claims cognizable under both the FHA and the ECOA); *Masudi v. Ford Motor Credit Co.*, 2008 WL 2944643 (E.D.N.Y. 2008) (Recognizing the ECOA allows disparate impact actions); *Zamudio v. HSBC North America Holdings, Inc.*, 2008 WL 517138 (N.D.Ill. 2008) (Filing disparate impact claims are available under both the ECOA and the FHA); *Graoch Associates # 33. L.P. v. Louisville/Jefferson County Metro Human Relations Com'n*, 508 F.3d 366 (6th Cir. 2007) (Discussing burden-shifting in disparate impact claims brought under the FHA); *Beaulialice v. Federal Home Loan Mortg. Corp.*, 2007 WL 744646 (M.D.Fla. 2007) (Finding the plaintiff may bring a disparate impact claim under the FHA); *Affordable Housing Development Corp. v. City of Fresno*, 433 F.3d 1182, 1195 (9th Cir. 2006) (Recognizing disparate impact claims under the FHA).

[31] *See* 12 C.F.R. § 1002 Supp. I § 1002.6(a)-(2).

[32] Regulation B, ECOA's implementing regulation, specifically provides that Congress intended the ECOA to include disparate impact liability:

> The effects test is a judicial doctrine that was developed in a series of employment cases decided by the U.S. Supreme Court under Title VII of the Civil Rights Act of 1964 (42 U.S.C. 2000e et seq.), and the burdens of proof for such employment cases were codified by Congress in the Civil Rights Act of 1991 (42 U.S.C. 2000e–2). Congressional intent that this doctrine apply to the credit area is documented in the Senate Report that accompanied H.R. 6516, No. 94–589, pp. 4–5; and in the House Report that accompanied H.R. 6516, No. 94–210, p.5. The Act and regulation may prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact. 12 C.F.R. pt. 1002 Supp. I, para. 6(a) –2.

[33] *See* 59 Fed. Reg. 18,266, 18,271 (1994). The statement was adopted by HUD, OFHEO, DOJ, OCC, OTS, FRB, FDIC, FHFB, FTC, and NCUA, members of the Interagency Task Force on Fair Lending.

decision to extend, renew, or continue credit."[34] Regulation B further provides that "creditor" means "a person, who, in the ordinary course of business, regularly participates in the decision of whether or not to extend credit" and expressly includes an "assignee, transferee, or subrogee who so participates."[35] The Commentary to Regulation B makes clear that an assignee is considered a "creditor" when the assignee participates in the credit decision. The Commentary provides that a "creditor" "includes all persons participating in the credit decision" and that "[t]his may include an assignee or a potential purchaser of the obligation who influences the credit decision by indicating whether or not it will purchase the obligation if the transaction is consummated."[36] Thus, while Ally may continue to argue that it is not liable for the disparities or otherwise attempt to distinguish itself, its practices of evaluating an applicant's information, establishing a buy rate, and then communicating that buy rate to the dealer, indicating that it will purchase the obligation at the designated buy rate if the transaction is consummated, very likely make Ally a creditor under ECOA.

Ally has argued that it is not liable under the ECOA because Regulation B provides that "[a] person is not a creditor regarding any violation of the [ECOA] or [Regulation B] committed by another creditor unless the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction."[37] This provision limits a creditor's liability for another creditor's ECOA violations under certain circumstances. But it does not limit Ally's liability for its own violations stemming from the disparate impact of its markup and compensation policy.

The Bureau also recently affirmed its position in the Auto Discrimination Bulletin that indirect auto lenders are creditors under ECOA and Regulation B given the lender's participation in the transaction.[38] As set forth in the Bulletin, "[a]n indirect auto lender's markup and compensation policies may alone be sufficient to trigger liability under the ECOA if the lender regularly participates in a credit decision and its policies result in discrimination. The disparities triggering liability could arise either within a particular dealer's transactions or across different dealers within the lender's portfolio. Thus, an indirect auto lender that permits dealer markup and compensates dealers on that basis may be liable for these policies and practices if they result in disparities on a prohibited basis."[39]

C. Omitted Variables

While the statistical model employed by the Bureau provides statistical confidence that African Americans, Hispanics, and Asians pay higher dealer markups than similarly-situated non-Hispanic whites, Ally has argued that the statistical model omits certain unobserved variables and, therefore, the Bureau's estimated disparities may be biased upward and may not be evidence of discrimination. Ally conducted its own regression analyses and included a number of additional

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[34] 15 U.S.C. § 1691a(e).

[35] 12 C.F.R. § 1002.2(*l*).

[36] 12 C.F.R. pt. 1002, Supp. I, § 1002.2, ¶ 2(*l*)-1.

[37] Ally PARR Response at 10 (quoting 12 C.F.R. § 1002.2(1)),

[38] *See* CFPB Bulletin 2013-02, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act* (March 21, 2013), available at http://files.consumerfinance.gov/f/201303_cfpb_march-Auto-Finance-Bulletin.pdf.

[39] *Id.; see also* cases cited in note 1 *supra* rejecting argument that indirect auto lenders are not creditors under ECOA.

variables that it argued were appropriate for inclusion in the model, including:

- The amount financed of the retail installment contract;
- The advance rate (*i.e.*, amount financed to wholesale collateral value for used or invoice for new);
- Indicators for whether the vehicle financed was (a) new or (b) used and the vehicle model year was (i) no more than two years older than the current model year, (ii) between three to five years older than the current model year and (iii) six or more years older than the current model year;
- Indicators for the Ally credit tier assigned;
- Indicators for the applicant's credit bureau score by quartile, along with an indicator for missing credit bureau scores;
- Three indicators for instances where the contract date (i) was on the same day as the application date, (ii) was on a day prior to the application date or (iii) was on a day after the application date;
- An indicator for whether the term was greater than 60 months or 60 months or less; and
- Indicators for the average rate spread of dealers (as determined by Primary Dealer Number ("PDN")) for contracts assigned to Ally in the data set for dealers where such average was less than 0.5 percentage points; greater than or equal to 0.5 percentage points, but less than 1.5 percentage points; and greater than or equal to 1.5 percentage points.

Of the above-mentioned variables, Ally maintains that creditworthiness (as measured by credit tier assignment and credit bureau score) and a control based on classification of dealers' average markup (low, low medium, medium, high medium, high) explain a substantial portion of the identified disparities. Ally concluded that based on its regression analysis, disparities are reduced from the 29 basis point disparity observed for African Americans in the Office of Research's analysis to approximately nine basis points, and from 20 basis points for Hispanics to approximately five basis points. For Asians, the disparity is reduced from 20 basis points to approximately 11 basis points.

Bureau staff believes that it is inappropriate to include the various controls suggested by Ally in our analysis. While Ally's suggested controls may reduce the disparities because they are correlated with race and/or ethnicity, they should not be included in the analysis because they neither model the markup policy nor reflect a legitimate business need. For example, while there is certainly a correlation between an applicant's creditworthiness and his/her markup, Ally has failed to meet its burden of demonstrating that a borrower's creditworthiness is a necessary factor in a dealer's assignment of markup.

Likewise, Bureau staff believes it is inappropriate to include a control for average dealer markup classifications in the analysis because our focus is on the disparate impact of dealer markup *across* Ally's portfolio as opposed to at the *dealer* level, which is more likely to capture evidence of disparate treatment at particular dealers. However, in the event that Ally makes the argument that a control for average dealer markup is appropriate and in the course of negotiations Bureau staff agrees to its inclusion in the model, the Office of Research, has concluded

that the disparities are reduced to 19 bps for African Americans, 13 bps for Hispanics, and 14 bps for Asians.

Furthermore, to determine whether the disparities in markup are due to characteristics not accounted for by the statistical model, examiners compared 145 retail installment contracts of African-American and Hispanic borrowers, to one or more retail installment contracts of non-Hispanic White borrowers. Based on this comparative file review, examiners could not determine non-discriminatory reasons for the disparities in the dealer markups, and management was unable to provide explanations for the disparities. After evaluating Ally's PARR response, conducting several additional meetings with Ally, and comparative file review, staff believe that our analysis supports the reported results.

D. Proxy

Ally also asserts that the preliminary analysis cited in the PARR letter did not take into account or otherwise correct for errors involved with the use of proxies. Ally contends that the potential for error in relying on name or geographic coding in non-mortgage fair lending examinations has been specifically acknowledged by the Government Accountability Office[40] and that the Bureau should acknowledge this potential for error when evaluating the results.

The Government Accountability Office report, however, counseled in favor of further research with respect to proxy methodology and it did not consider the proxy methodology utilized by the Office of Research in this matter. Furthermore, courts have accepted the use of reliable proxy methods in a variety of discrimination suits, including ECOA actions,[41] Voting Rights Act suits,[42] employment discrimination actions,[43] and constitutional challenges to jury pool selections.[44] At the same time courts have recognized that proxies are merely estimations of

[40] Testimony of Orice M. Williams, Director Financial Markets and Community Investment, Government Accountability Office, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, July 17, 2008 at 9, available at http://democrats.financialservices.house.gov/hearing110/williams071708.pdf.

[41] *See, e.g., United States v. Union Auto Sales, Inc.*, 490 F. App'x 847, 849 (9th Cir. 2012) ("classification of 'Asians' and 'non-Asians' did not render the ECOA claim any less plausible" because "[t]he link between names and racial categorization for the purposes of both antidiscrimination law and discriminatory conduct is well-established").

[42] *See, e.g., Benavidez v. City of Irving*, 638 F. Supp. 2d 709, 717 (N.D. Tex. 2009) ("The Spanish surname may be used as a proxy for Hispanic ethnicity when self-identification is not practical."); *United States v. Vill. of Port Chester*, No. 06 Civ. 15173(SCR), 2008 WL 190502, at *9 n.13 (S.D.N.Y. Jan. 17, 2008) ("Experts for both parties used the Census Bureau List of Spanish Surnames to calculate the number of Hispanic voters in a particular area ... Neither party disputes that Spanish Surname Analysis is an accepted methodology.").

[43] *See, e.g., E.E.O.C. v. Autozone, Inc.*, No. 00-2923 Ma/A, 2006 WL 2524093, at *5 (W.D. Tenn. Aug. 29, 2006) (finding that "it was reasonable for [the government's expert] to use census proxy data rather than the actual applicant data"); *I.M.A.G.E. v. Bailar*, 518 F. Supp. 800, 807 (N.D. Cal. 1981) ("[M]any Title VII discrimination suits have relied on Spanish surnames as an identifier for evaluating adverse impact and for affecting relief."); *Guardians Ass'n of New York City Police Dep't, Inc. v. Civil Serv. Comm'n of City of New York*, 431 F. Supp. 526, 530 (S.D.N.Y. 1977), *vacated and remanded on other grounds*, 562 F.2d 38 (2d Cir. 1977) (holding that the use of three statistical methods to estimate race and national origin, including the proxy methods of surname analysis and geocoding, was "clearly trustworthy"); *Com. of Pa. v. O'Neill*, 348 F. Supp. 1084, 1086 (E.D. Pa. 1972), *aff'd in relevant part, vacated in part on other grounds*, 473 F.2d 1029 (3d Cir. 1973) (finding expert's race estimations from geocoding "reasonable").

[44] *United States v. Reyes*, 934 F. Supp. 553, 560-62 (S.D.N.Y. 1996) (accepting the use of geocoding to estimate race and noting that an expert explained that the method is "commonly used"); *United States v. Gerena*, 677 F. Supp. 1266, 1270 (D. Conn. 1987), *aff'd sub nom. United States v. Maldonado-Rivera*, 922 F.2d 934 (2d Cir. 1990) (criminal

protected characteristics and their predictive power may be limited in some circumstances.[45] The Office of Research's proxy methodology uses the commonly-accepted proxy techniques of surname analysis and geocoding and improves their accuracy. The Office of Research has been able to compare the success of various methods at identifying race and ethnicity using one lender's HMDA data, and has found that its proxy method does a better job than common alternatives, including threshold-based methodologies such as those employed by Ally.

While not raised by Ally, the Office of Research also evaluated an alternative methodology to estimate the size of any racial or ethnic disparities based on proxies that has been raised by another institution. The alternative methodology reduced the disparities for African Americans from 29 basis points to 15 basis points, for Hispanics from 20 to 15 basis points and for Asians from 21 to 15. After an extensive review, the staff believes that this alternative approach almost certainly underestimates disparities and thus consumer harm. Although it is possible that the original estimation approach may overestimate disparities in some instances, the Office of Research also concluded that it is reasonable and appropriately estimates disparities under the particular facts of this matter. Although proxying for race and ethnicity is less powerful evidence than self-reported race and ethnicity data, both the case law and the improved accuracy of the Office of Research's method weigh in favor of a court accepting our methodology.

E. Subvented Loans

Ally asserted that it carries out numerous subvented programs under contract with manufacturers. Ally explained that the financing subsidies in those programs vary considerably, as do other requirements of the programs. In particular, some subvention programs allow a markup of [redacted] basis points and some do not allow for any markup. In those programs that allow markup, dealers routinely impose the full mark-up allowed by the program, typically [redacted] basis points. Ally contends that these aspects of the program, by their nature, have significant effects on dealer and vehicle purchaser behavior and the Office of Research failed to consider such aspects in its analysis.

While such an explanation seems like a plausible way of explaining the disparities, Ally has refused to provide any supporting evidence related to the parameters of the various subvention programs, citing confidentiality. Nevertheless, based upon the information provided by Ally, the Office of Research opined that most consumers in the subvented program received either a [redacted] basis point markup or a [redacted] basis point markup, with few borrowers receiving any other markup amount. The Office of Research excluded from its analysis all subvented loans that received a [redacted] basis point buy rate (which potentially reflected [redacted] offers for which no markup would be available) and calculated the above-mentioned disparities for African Americans and Hispanics for subvented loans. Staff acknowledges that the analysis with respect to subvented loans would have

defendant's expert and federal government's expert agreed that Spanish surname analysis "is an accepted method of identifying individuals of Hispanic origin").

[45] Some courts have expressed skepticism of surname analysis where its accuracy was called into question in that particular instance. *See, e.g., I.M.A.G.E.*, 518 F. Supp. at 806-07 (questioning the probative value of defendant's surname analysis because of, among other reasons, a large population of Portuguese and Filipinos residents in the area with names on the Spanish surname list). Even where courts are skeptical of surname analysis, they may consider it as evidence if its usefulness can be shown. *See, e.g., Rodriguez v. Bexar Cnty.*, 385 F.3d 853, 866, n.18 (5th Cir. 2004) (expressing its opinion that Spanish surname analysis is "novel and highly problematic," but upholding the district court's consideration of it and allowing it in future cases upon a "strict showing of its probativeness").

benefited from additional details regarding the specific details of the subvention program, including program caps.

Bureau staff has concluded that it is appropriate to seek settlement relief for the disparities identified in the subvented loans. In the event that Ally is able to provide evidence and confirms its explanation, it may be necessary to adjust or eliminate our request for damages related to the identified disparities in the subvented loans.

F. Statistical Significance

Ally also argues in its PARR response that given the very large number of transactions that are analyzed in the model, the statistically significant disparities identified by the Bureau do not have sufficient practical or legal significance to support a violation. Further, Ally maintains the error implicit in the analysis that relies on proxies makes the statistical significance calculation misleading by implying a precision that does not exist.

As a matter of law, we would contend that statistical significance alone is sufficient to make a prima facie showing of discrimination.[46] Direct damages stemming from discrimination in the amount of almost $200 per consumer are not insignificant. Moreover, even when considering what the Bureau's tolerance may be in these circumstances, we can infer from a number of DOJ cases that DOJ deems mortgage pricing disparities of 5 basis points to be actionable when reflected through APR and deems mortgage pricing disparities of approximately 20 basis points to be actionable when reflected through fees. Because it is examining a difference in interest rate, the analysis of dealer markup for disparities shares features of an APR analysis.

G. Totality of the Transaction

Ally argues that the Bureau's analysis does not account for the fact that the revenue generated by the rate spread is only one component of the profit that the dealer may achieve with respect to the entire transaction of selling a car. Because the vehicle sales price, the trade-in value, the sale of any ancillary products and services and the vehicle financing are component parts of a single transaction, Ally states that dealer rate spread cannot be properly isolated from the entire transaction in light of the multi-faceted dynamics of the particular transaction.

As a legal matter, ECOA prohibits discrimination in the credit transaction irrespective of any other elements of a sales transaction. As a result, if Ally's markup policy results in a disparate impact in the pricing of its auto financing, it is a violation of ECOA. In any event, Installment Markets has considered Ally's argument and has concluded, contrary to the crux of Ally's argument, that dealers would likely seek to maximize each aspect of the transaction and not treat different elements of the transaction as trading off with one another.

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[46] *Stagi v. Nat'l R.R. Passenger Corp.*, 391 F. App'x 133, 140 (3d Cir. 2010) ("As 'practical' significance has not been adopted by our Court, and no other Court of Appeals requires a showing of practical significance, we decline to require such a showing as part of a plaintiff's prima facie case."). *But see Waisome v. Port Auth. of New York & New Jersey*, 948 F.2d 1370, 1376 (2d Cir. 1991) (finding that "though the disparity was found to be statistically significant, it was of limited magnitude" and citing sources explaining the difference between statistical and practical significance).

VI. PROPOSED PARAMETERS FOR SETTLEMENT NEGOTIATIONS

A. Injunctive Relief

We seek authority to negotiate a settlement with Ally that would include injunctive provisions to correct the identified ECOA violations and prevent future ECOA violations. We seek authority to negotiate, in our discretion, prospective compliance measures, which will likely include either or both:

- An alternative compensation structure that eliminates discretionary pricing, which meets the following principles:
    - It eliminates or significantly minimizes the fair-lending risk that may arise from dealer discretion in setting the contract APR such that the Bureau—absent the later development of an unexpected harm—would not need to monitor the dealer compensation for fair-lending risk or could significantly reduce the monitoring required;
    - It provides transparency to consumers regarding the terms of the dealers' compensation (*e.g.*, it is amenable to a public education campaign or consumers will be able to shop the rates);
    - The proposal appears to be a sustainable proposal for compensating dealers for the work they perform; and
    - It does not create or exacerbate other fair-lending risks or other harms to consumers that are equal to or worse than the risks and harms of the current system; and
- Significant enhancements to Ally's auto lending compliance program, including implementing a program with the following elements:
    - sending communications to all participating dealers explaining the ECOA, stating the lender's expectations with respect to ECOA compliance, and articulating the dealer's obligation to mark up interest rates in a non-discriminatory manner in instances where such markups are permitted;
    - conducting regular analyses of both dealer-specific and portfolio-wide loan pricing data for potential disparities on a prohibited basis resulting from dealer markup and compensation policies and with specific terms of the analyses that reflect only those controls that are appropriate for a dealer markup analysis;
    - commencing prompt corrective action against dealers, including restricting or eliminating their use of dealer markup and compensation policies or excluding dealers from future transactions, when analysis identifies unexplained disparities on a prohibited basis, with appropriate cutoffs to trigger action ranging from 5-15 bps; and
    - promptly remunerating affected consumers when unexplained disparities on a prohibited basis are identified either within an individual dealer's transactions or across the indirect lender's portfolio, with appropriate cutoffs to trigger action ranging from 5-10 bps.

Although we will attempt to negotiate a settlement that contemplates a non-discretionary compensation system, we anticipate that at least for some time, Ally will have to employ an enhanced CMS to prevent future ECOA violations, and therefore we anticipate that any settlement agreement will include enhanced CMS provisions.

B. Restitution

We also seek authority to negotiate a settlement that will provide remediation to consumers based on:

- Consumer direct damages in the range of $10 million to $41 million (paid as money or as a note rate reduction), with the upper figure representing overpayment over the full life of the loan originated during the exam period from April 1, 2011 to March 31, 2012.

  These numbers are based upon calculations from the Office of Research related to the numbers of consumers affected and the average amount of disparity. The maximum figure in the range is derived from a full calculation of damages for all consumers and for both non-subvented and subvented loan types. The lower figure in the range accounts for potential discounting factors during settlement negotiations such as (1) eliminating a demand for restitution for subvented loans; (2) limiting the life of the loan to reflect early payment; and (3) including possible additional controls into the model, such as a dealer control. Of note, to the extent that victims continue to hold their loans with Ally, we also seek authorization to have Ally provide the monetary relief that relates to future loan payments through the form of a note rate reduction rather than through payment of damages.

- A fund for consumer direct damages estimated to be in the range of $14 million to $57 million (paid as money or as a note rate reduction), representing overpayment over the full life of the loan for consumers who may have been subject to discriminatory mark ups during the time period from April 1, 2012 to the present.

  These numbers are based upon an extrapolation of the Office of Research's estimated damages over a year-and-a-half period, with an 8% decrease representing the drop in Ally's loan origination volume from 2011 to 2012. Given the fact that the same policy was in place during the time period, it is reasonable to rely on the Office of Research's damages calculations. We anticipate reaching agreement with Ally as to the method of identifying the actual damages and victims. As noted above, to the extent that victims continue to hold their loans with Ally, we also seek authorization to have Ally provide the monetary relief that relates to future loan payments through the form of a note rate reduction rather than through payment of damages.

- Consumers' indirect emotional distress damages for consumers who initiated loans during the time period from April 1, 2011 to March 31, 2012, up to $32 million.

  These numbers are based upon past DOJ precedent for calculating emotional distress damages. Typically, the DOJ considers $500 per person as an appropriate estimate for emotional distress damages in the context of a mortgage loan. Given that this matter involves automobile loans, staff reduced the indirect damages to $150 per person. As a result, the top range represents $150 per person for each of the estimated 213,535 African American, Hispanic, and Asian consumers. The lower range reflects $0 per person, as we seek discretion not to seek indirect damages, depending on the agreed upon amount of direct damages.

- Consumers' indirect emotional distress damages for consumers who initiated loans during the time period from April 1, 2012 to the present, up to $44 million.

    These numbers are based upon past DOJ precedent for calculating emotional distress damages and are based upon an extrapolation over a year-and-a-half period with an 8% decrease representing the drop in Ally's loan origination volume from 2011 to 2012. We anticipate reaching agreement with Ally as to a method of identifying the victims. The top range represents $150 per person, and the lower range reflects $0 per person, as we seek discretion not to seek indirect damages, depending on the agreed upon amount of direct damages.

We seek authority to negotiate, in our discretion, a methodology to operationalize the consumer remuneration as detailed above. Based upon our conversations with outside economists who have prior experience in implementing similar consumer remuneration, several options exist, including: (1) mailing cards to all potentially harmed consumers and requesting them to identify their race and/or national origin and distributing damages based on that identification; (2) assigning race and national origin using thresholds, and distributing damages based on those assignments; (3) a hybrid approach combining a threshold and mailing cards; and (4) providing refunds proportionally based on each individual's probability of being a particular race and/or national origin. We also seek authority to negotiate, in our discretion and depending on the method selected to identify victims, whether to have Ally administer the relief or require a third party administrator.

Based on the available data, the range of consumer relief may be as high as $174 million. While staff believes there is a sufficient basis for seeking up to $174 million in damages, staff seeks authority to settle for as low as $24 million for consumer relief to account for litigation risk and other potential arguments from Ally, including the possibility that the damages related to subvented loans will not be pursued and the possibility that we may accept some of the controls suggested by Ally in the interest of reaching a resolution in this matter.[47]

C. Civil Money Penalties

Any person who violates, through any act or omission, any provision of Federal consumer financial law may be required under the CFPA to pay a civil money penalty. 12 U.S.C. § 5565(c). The Act provides for three tiers of penalties depending upon the nature of the conduct at issue – up to $5,000 per day for any violation regardless of knowledge (Tier 1); up to $25,000 per day for recklessly engaging in a violation (Tier 2); and up to $1,000,000 per day for knowing violation (Tier 3). 12 U.S.C. § 5565(c)(2).[48]

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[47] In preparation for potential settlement negotiations, the Office of Research was asked to calculate direct damage figures based upon Ally's stated formulas to gauge Ally's potential settlement position. The damage figures using Ally assumptions were approximately $5.4 million or roughly 13% of the Bureau's calculations. The Bureau's calculations are reasonably supported by the data, but there is a significant gap in direct damage calculations depending on which formula is utilized.

[48] The Bureau has a reasonable basis for assessing Civil Money Penalties (CMPs) at a First Tier violation level under the CFPA, 12 U.S.C. § 5565(c)(2). By its nature, disparate impact, for which there is the strongest evidence, results from a facially neutral policy and can usually only be verified with *ex post facto* analysis. As a result, depending

Pursuant to 12 U.S.C. § 5565(c)(3), the Bureau must consider the following factors to determine an appropriate penalty:

(1) the Bank's financial resources and any demonstrated good faith;
(2) the gravity of the violation or failure to pay;
(3) the severity of the risks to or losses of the consumer, which may take into account the number of products or services sold or provided;
(4) the Bank's history of previous violations; and
(5) such other matters as justice may require.

Bureau staff believes that a penalty of approximately $10-30 million is appropriate. *First*, as noted above, Ally is [redacted] auto loan lender in the United States.[49] In 2012, Ally originated [redacted] automobile loans for [redacted]. As of December 31, 2012, Ally's domestic consumer automobile portfolio totaled approximately [redacted]. *Second*, such a range will ensure an appropriate ratio of consumer harm to penalty of approximately 3:1. *Third*, it is of sufficient magnitude to represent a strong deterrent but not jeopardize the viability of the company. The alleged conduct is illegal discrimination on the basis of race and national origin that impacted over 200,000 consumers for loans originated in a single year, which is a very serious violation, and staff believe that the proposed range reflects that seriousness. *Fourth*, such a range is consistent with past Bureau precedent.[50] Additionally, we may be willing to accept an amount on the lower end of the range if Ally negotiates more favorable remediation for consumers.

D. Summary of Proposed Settlement Parameters

Accordingly, and consistent with the discussion above, staff seek authority to negotiate a settlement in this matter, which would include a proposed consent decree, containing terms within the following parameters, detailed above:

1) An injunction, with various affirmative requirements, prohibiting Ally from violating the ECOA; and an order that requires:

2) Implementing an alternative dealer compensation structure and/or significant enhancements to its auto lending compliance monitoring program;

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on the circumstances, it is difficult to argue that disparate impact violations are reckless or knowing, which results in second and third tier violations, respectively. *See* 12 U.S.C. § 5565(c)(2). However, the fact that the Federal Reserve Bank had previously issued an MRA requiring Ally to improve its monitoring of fair lending risk for its consumer automotive line of business in 2010 yet Ally chose not to implement such a program until the CFPB review commenced, strongly supports a first tier violation. In any event, even assuming penalties were assessed under the second and third tiers, based on 213, 535 violations alone, the penalties could be as high as $427 million and $213 million, respectively.

[49] Based on 2011 Experian data.

[50] The most comparable precedent may be the CFPB's resolution with American Express which impacted 250,000 consumers and totaled $85 million in consumer remuneration. In that matter, the CMPs totaling $14.1 million. Given the invidious nature of discrimination, it may warrant a higher CMP than American Express.

3) Ally to pay restitution to African-American, Hispanic, and Asian borrowers who were injured by Ally's discriminatory practices in an amount between $24 million and $174 million, reflecting direct and indirect damages to those consumers;

4) Civil money penalties between $10 and $30 million; and

5) Contains additional provisions generally consistent with efforts to remediate the conduct described in this memo.

VII. LIKELIHOOD OF SETTLEMENT AND LITIGATION RISK

Some of the claims being made in this case present issues, such as use of proxying and reliance on the disparate impact doctrine that would pose litigation risks meriting serious consideration prior to taking administrative action or filing suit in district court. Nevertheless, Ally may have a powerful incentive to settle the entire matter quickly without engaging in protracted litigation. AFI owns certain subsidiaries, primarily insurance companies that it will have to divest if it is unable to satisfy the requirements to qualify as a financial holding company under the Bank Holding Company Act (BHCA). The Federal Reserve Board granted it a final one-year extension under the BHCA in December 2012, which expires December 24, 2013. In order to convert to a financial holding company, AFI and its bank subsidiary must, among other requirements, be considered well-managed under the BHCA. As such, Ally may be strongly inclined to reach a timely and robust resolution of this matter if it can potentially result in AFI successfully converting to a financial holding company. Recent discussions with Ally on October 3 in which Ally expressed a strong willingness to settle this matter quickly are consistent with this analysis.

Bureau staff is also recommending referring this matter to the DOJ. Although we believe that Ally will be incented to settle with the Bureau in order to minimize the risk that the DOJ will open its own independent investigation, it is possible that Ally will refuse to enter into a settlement agreement with the Bureau until it has assurances from the DOJ that it will not act independently. If Ally agrees to an expeditious resolution, although we still will refer the matter to the DOJ, we will proceed to settle independently of DOJ. If we are unable to reach an immediate settlement with Ally, we would seek to work jointly with the DOJ. Should the DOJ opt to join the Bureau's investigation, that may provide an additional basis for Ally to settle.

Thus, the likelihood of settling for an amount in our authority range appears reasonable; and staff believes that Ally recognizes the legal and reputational risks of engaging in protracted litigation, particularly in light of AFI's desire to achieve financial holding company status.

VIII. CONCLUSION

Staff seeks settlement authority for $24 to $174 million for consumer damages. This range represents a realistic assessment of the Bureau's data, analysis, and litigation risk. In addition, the range of Civil Money Penalty authority, in the range of $10 million to $30 million, takes into account the factors set forth in the CFPA, § 1055. Overall, settlement in the aggregate range from $34-$204 million will make consumers whole, and impose a significant civil money penalty. Staff

also seeks authority to negotiate appropriate injunctive relief, including enhanced CMS and/or the adoption of a non-discretionary compensation program for Ally's indirect auto lending program.

Attachments
Attachment A: Term Sheet
Attachment B: Fair Lending Potential Action and Request for Response Letter
Attachment C: Ally's Response to the FL PARR