CLIENT UPDATE

THE CFPB ISSUES BULLETIN ON INDIRECT AUTO LENDING AND COMPLIANCE WITH THE EQUAL CREDIT OPPORTUNITY ACT

NEW YORK
Mary Beth Hogan
mbhogan@debevoise.com

Eric P. Alpert
epalpert@debevoise.com

WASHINGTON, D.C.
Satish M. Kini
smkini@debevoise.com

David A. Luigs
daluigs@debevoise.com

Liz Alspector
lalspector@debevoise.com

On March 21, 2013, the Consumer Financial Protection Bureau ("CFPB") issued Bulletin 2013-02 (the "Bulletin") warning indirect auto lenders of the potential for fair lending liability raised by 'dealer markups' – a practice that affords auto dealers discretion to vary interest rates on consumer auto loans.[1] The Bulletin is styled as guidance for indirect auto lenders regarding compliance with the fair lending requirements of the Equal Credit Opportunity Act ("ECOA") and its implementing regulation, Regulation B ("Regulation B"), and has the potential to reshape the auto lending industry.

The Bulletin has drawn significant attention and, from some quarters, immediate adverse reaction. For example, two auto industry trade groups, the National Automobile Dealers Association and National Association of Minority Automobile Dealers, issued a joint statement questioning the CFPB's approach and arguing that the Bulletin will harm consumers by reducing the availability of low-cost auto financing.

1 In an indirect lending model, lenders provide the dealer with the 'buy rate' at which they would purchase a loan for a particular borrower based on information collected by the dealer. Under dealer markup, dealers may charge consumers a higher interest rate than the lender's buy rate and are then compensated based on the difference in interest rates.

In the Bulletin, the CFPB indicates that indirect auto lenders, including depository and non-bank institutions, should ensure that their dealer markup and compensation policies comply with ECOA and Regulation B and suggests development of "robust" compliance programs for such purpose. The Bulletin also indicates that some lenders should consider taking additional steps to address fair lending risks, such as monitoring and corrective actions, or replacing dealer markups with other compensation methods, as discussed below.

The Bulletin, which was issued along with a press release titled: "Consumer Financial Protection Bureau to Hold Auto Lenders Accountable for Illegal Discriminatory Markup," suggests that the CFPB intends to focus closely on auto dealer markups, including through its examination and enforcement authority. Accordingly, the CFPB's guidance should be taken seriously by indirect auto lenders, including those not yet under the CFPB's examination jurisdiction.

BACKGROUND ON ECOA

ECOA generally prohibits "creditors" from discriminating against credit applicants on any prohibited basis.[2] ECOA defines the term "creditor" broadly to include "any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."[3]

In the past, the CFPB has indicated that, as it exercises its supervisory and enforcement authority, it intends to apply the fair lending doctrine of disparate impact.[4] Under the disparate impact doctrine, also known as the "effects test," a creditor may be liable for practices that result in disproportionately negative impacts on a prohibited basis, even though the creditor has no intent to discriminate and its practices are facially neutral. Disparate treatment, by contrast, requires intent or motive. Press reports from last month indicated that the CFPB was pursuing enforcement actions against at least four banks for dealer markup practices on an ECOA disparate impact theory.

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2 Prohibited bases include race, color, religion, national origin, sex, marital status, age, the fact that all or part of an applicant's income is derived from any public assistance program or the prior exercise of rights under the Consumer Credit Protection Act. 15 U.S.C. § 1691(a).

3 15 U.S.C. § 1691a(e).

4 *See* CFPB Bulletin 2012-04 (Apr. 18, 2012). CFPB Director Richard Cordray stated last month that "lender policies that provide incentives for brokers or loan officers to negotiate higher rates," such as dealer markup policies, appeared to result in minority borrowers paying more for auto loans. Richard Cordray, Director, CFPB, Prepared Remarks at a Meeting of the National Association of Attorneys General (Feb. 26, 2013).

THE BULLETIN

The Bulletin makes clear that, although the CFPB does not have statutory authority to regulate auto dealers directly, the agency intends to target auto finance practices through enforcing ECOA and Regulation B against indirect auto lenders.[5] CFPB staff have stated that the Bulletin is not intended to change the standards for application of ECOA and Regulation B; rather, the guidance merely articulates the CFPB's intention to enforce in the auto finance industry those same standards, including disparate impact, through regulating indirect auto lenders.

The Bulletin states with clarity that certain standard industry practices likely will cause indirect auto lenders to fall within the broad definition of "creditor" under ECOA and Regulation B. The Bulletin provides two examples of when the CFPB will consider an indirect auto lender a "creditor" as a result of "regularly participating" in the decision on whether to extend credit:

- the lender "evaluates an applicant's information, establishes a buy rate, and then communicates that buy rate to the dealer, indicating that it will purchase the obligation at the designated buy rate if the transaction is consummated"; and
- the lender "provides rate sheets to a dealer establishing buy rates and allows the dealer to mark up those buy rates," after which the lender purchases the contract from such a dealer.

The CFPB notes that indirect auto lenders may also be considered "creditors" under different arrangements, as the illustrations are not meant to be exhaustive.

The CFPB's Theory of Liability

Under the Bulletin, an indirect auto lender that is a creditor would violate ECOA if the lender's policy permitted dealer markup and compensation and resulted in a disparate impact. The Bulletin states that "disparities triggering liability could arise either within a particular dealer's transactions [with an indirect auto lender] or across different dealers within the lender's portfolio." Because the CFPB will be applying the effects test, this statement could mean that data indicating differences in finance charges paid by different classes of borrowers could be enough to trigger fair lending liability merely if the indirect auto lender permitted dealer markup and compensated on that basis.

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5 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1029 (2010) (Subject to certain exceptions, the Dodd-Frank Act carves out from CFPB jurisdiction certain "motor vehicle dealer[s] that [are] predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.").

Further, indirect auto lenders may be liable for fair lending violations if they knew or had reasonable notice of a dealer's discriminatory conduct – a possible circumstance if the indirect auto lender implements a compliance program that includes monitoring for fair lending violations, discussed below. In other words, the Bulletin clarifies that an indirect auto lender could be liable for violations despite Regulation B's safe harbor limiting a creditor's liability for another creditor's violation.[6]

CFPB Recommended Compliance Policies

The Bulletin recommends certain actions be taken by indirect auto lenders to ensure compliance with ECOA and Regulation B. With respect to dealer markup and compensation policies, the CFPB suggests: (1) controls on or revisions to such policies, in addition to ongoing monitoring for disparate impacts; or (2) altogether eliminating dealer discretion to mark up buy rates and compensating auto dealers by using a different mechanism that does not result in a disparate impact (such as flat fees per transaction).

In line with previous guidance it has issued, the CFPB also suggests that indirect auto lenders should have "a robust fair lending compliance management program," which may include reviews of policies and procedures and analyses for disparate impacts.[7] Because indirect auto lenders typically do not collect data on borrower characteristics such as sex and race, the CFPB has suggested using proxies, such as last name and geography, to monitor for disparate impacts. The CFPB has indicated that it will publish the proxy methodology it uses for disparate impact analyses, although it has not yet done so.

In addition, the CFPB suggests that indirect auto lenders that permit dealer markup and compensation practices consider additional measures to address the "significant fair lending risks" the CFPB perceives exist with those practices. Among the measures that the CFPB suggests are:

- Communicating the lender's expectation with respect to ECOA compliance to dealers;
- "Regular analyses" of portfolios for disparate impacts;
- Prompt corrective action against dealers, such as restrictions on markups, if disparate impacts related to the dealer are identified; and

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6 Regulation B's safe harbor provides that a person is "not a creditor regarding any violation of [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." 12 CFR 1002.2(l).

7 CFPB, *Supervisory Highlights: Fall 2012* (Oct. 31, 2012), *available at* http://www.consumerfinance.gov/reports/supervisory-highlights-fall-2012/.

- Remunerating affected consumers when unexplained disparities exist.

CONCLUSION

The Bulletin clearly signals the CFPB's determination to treat indirect auto lenders as "creditors" under ECOA and its targeting of dealer markups under ECOA and Regulation B. Indirect auto lenders, including non-bank lenders that are not yet in the CFPB's examination jurisdiction, should consider adopting measures to address the CFPB's concerns. That may mean adopting monitoring programs, changing dealer compensation policies or communicating to dealers and staff the importance of compliance with ECOA. Given the CFPB's recent enforcement actions in the indirect auto lending industry, it may be wise for lenders to act promptly to mitigate the risk of potential ECOA liability.

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Please do not hesitate to contact us with any questions.

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