CLIENT UPDATE

CFPB PROPOSES AUTO FINANCE LARGER PARTICIPANT RULE, RELEASES FAIR LENDING SUPERVISORY REPORT AND PROXY METHODOLOGY

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On September 17, 2014, the Consumer Financial Protection Bureau (the "CFPB" or "Bureau") proposed a regulation to define "larger participants in a market for auto lending" (the "Proposed Rule").[1] When finalized, the Proposed Rule will bring certain non-bank auto lenders under CFPB supervisory authority — *i.e.*, the CFPB will have the power to conduct "bank-like" examinations at those companies for compliance with federal consumer financial protection laws. Once finalized and effective, non-bank auto lending will be the fifth industry that the CFPB has brought under federal supervision for the first time.

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1 Defining Larger Participants of the International Money Transfer Market, CFPB 2014-0024, CONSUMERFINANCE.GOV (Sept. 17, 2014), *available at* http://files.consumerfinance.gov/f/201409_cfpb_proposed-rule_lp-v_auto-financing.pdf; CFPB, *Using Publicly Available Information to Proxy for Unidentified Race and Ethnicity*, CONSUMERFINANCE.GOV (Sept. 17, 2014), *available at* http://files.consumerfinance.gov/f/201409_cfpb_report_proxy-methodology.pdf.

In the press release and in his comments at the field hearing to announce the Bureau's proposed approach to the auto finance industry, CFPB Director Cordray previewed the issues on which the CFPB would focus: use of deceptive marketing tactics, accurate provision of information to credit bureaus and fair customer treatment when collecting debts. The Bureau is proposing to extend its supervisory authority very broadly to cover 38 lenders, which make up an estimated 91% of the activity in the non-bank auto finance market.

In conjunction with issuing its Proposed Rule, the CFPB published its much anticipated white paper on the proxy methodology it uses for indirect auto fair lending analyses (the "White Paper"), and a special Supervisory Highlights Report ("Fair Lending Supervisory Report") on its fair lending indirect auto examinations of banks, which the Bureau stated has resulted in $56 million in remediation to consumers. The White Paper may help auto finance companies more effectively monitor their portfolios and dealers for disparate impact, as described in the CFPB's 2013 bulletin,[2] although questions remain about certain aspects of the analyses, including appropriate thresholds and analytical controls.

I. The Proposed Rule

The Proposed Rule explains which financing activities the Bureau intends to supervise in the auto finance market, sets out a test for capturing the larger auto finance lenders that the Bureau will supervise and adds certain types of auto leases to the definition of "financial product or service" that the Bureau may regulate.

Activities Defining the Auto Finance Market. The Proposed Rule would define a market for auto finance as those non-bank auto finance companies engaged in one or more of the following activities: (1) granting credit for the purpose of purchasing an automobile; (2) refinancing existing credit obligations or previously refinanced credit obligations that had been made for the purchase of an automobile; (3) purchasing or acquiring auto credit obligations, including refinancings; (4) providing automobile leases; and (5) purchasing or acquiring automobile lease agreements. The Proposed Rule collectively refers to these activities as "automobile financing."

This broad definition would capture the activities of specialty finance companies, such as those companies offering financing to subprime borrowers, captive non-bank auto finance companies affiliated with auto manufacturers, and "Buy Here Pay Here" finance companies, which are usually associated with certain dealers and provide financing to

[2] CFPB, Bulletin 2013-02, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act* (Mar. 21, 2013).

subprime borrowers. Excluded from the Proposed Rule's definition of automobile financing, however, are automobile title lending and securitizing automobile loans and leases.

Larger Participant Test. The proposed test to determine whether a non-bank qualifies as a larger participant in the auto finance market would be whether the non-bank had at least 10,000 aggregate annual originations in the prior year; if so, the non-bank would be supervised by the CFPB. As proposed, aggregate annual originations would be the sum of a non-bank's loans, leases, refinancings and the purchases or acquisitions of credit obligations (including refinancings) and leases.

The CFPB estimates that this test would capture over 90% of non-bank auto financing activity and would bring about 38 entities, or 7% of all nonbank firms in the automobile financing market under its supervisory authority. These 38 entities are estimated to serve 6.8 million consumers. The CFPB requests comments on whether a threshold above or below 10,000 annual originations would be more appropriate.

Automobile Leasing. The Bureau is proposing to include automobile leases as a criterion to define auto finance larger participants. While many consumer leases fall within the definition of "financial product or service" under the Dodd-Frank Act, the Proposed Rule would extend this definition to include a subset of auto leases that the Bureau states are permissible for banks to offer, but that are not already a covered "financial product or service" under the Dodd-Frank Act.[3]

Thus, the Proposed Rule would add to the definition of "financial product or service" any previously excluded automobile leases such as: (1) a full-payout lease — that is, a lease in which the lessor expects to realize the full cost of the item — or (2) a net lease that has a term of not less than 90 days. The CFPB states that this expanded definition will permit it to sufficiently cover those automobile leases that materially impact consumers and will also provide a clear delineation of those leases that qualify as auto financing under the Proposed Rule.

II. Timing

The CFPB has conducted four previous non-bank larger participant rulemakings covering other consumer finance markets. The timeframe for the CFPB's issuance of a proposed regulation, review and consideration of comments and issuance of the final rule with an "effective date," has ranged from approximately seven to eleven months:

[3] 12 U.S.C. § 24(Tenth); 12 U.S.C. § 5481(15)(A)(ii).

	Proposed Rule	Final Rule	Effective Date	Time from Proposed to Effective
Consumer Reporting Agencies	2/17/12	7/20/12	9/30/12	~7 months
Debt Collectors	2/17/12	10/31/12 *(corrected 12/7/2012)*	1/2/13	~11 months
Student Loan Servicers	3/28/13	12/3/13	3/1/14	~11 months
International Money Transfer Providers	1/23/14	9/9/14	12/1/14	~11 months
Auto Finance	9/17/14	*Likely spring 2015*	*Likely summer 2015*	

Based on this precedent, the anticipated effective date for the auto finance rule would be between April and August of 2015. Thus, firms that will be supervised under this rule could face CFPB examination starting in the summer of next year.

III. The Fair Lending Supervisory Report and White Paper on the Proxy Methodology

As detailed below, the Fair Lending Supervisory Report describes the CFPB's indirect auto lending supervisory activity to date and the White Paper provides information on the proxy methodology the Bureau uses when conducting fair lending analyses for indirect auto lending.

A. Fair Lending Supervisory Report

The Fair Lending Supervisory Report explains that the Bureau has conducted fair lending targeted examinations of indirect auto lending at several banks that represent over 30 percent of the indirect auto lending market. Based on these examinations, the Bureau observes that although these indirect auto lenders often limit dealer markup to 200 or 250 basis points, many lenders do not otherwise employ what the Bureau views as adequate monitoring or controls with respect to dealer participation. The Report also explains that the CFPB has taken non-public supervisory action, presumably by requiring corrective action and remediation through a Memorandum of Understanding, resulting in banks paying about $56 million to 190,000 borrowers.

Finally, in discussing its targeted fair lending reviews, the Bureau reiterated that analytical controls such as creditworthiness factors may not be appropriate as they are already included in the buy rate. This viewpoint reflects the approach other regulators generally take with regard to markups in the mortgage context. In some cases, however, a lender may be able to demonstrate that certain factors, already factored into the price of the loan, may independently affect the markup — *e.g.*, the market date or origination.

B. White Paper

Typically, auto lenders do not collect consumer demographic information, making it difficult to conduct fair lending analyses. Along with the new rule, the CFPB also released its White Paper outlining its approach for determining consumer demographic information for non-bank credit products, such as auto loans, based on publicly available data sources, as well as software code that could be used to implement the approach using commonly available statistical software and public data sources. The White Paper reiterates much of what the Bureau already has said publicly about its methodologies, but also provides new specific thresholds and steps used in its proxy analyses.

Specifically, the White Paper outlines the Bayesian Improved Surname Geocoding ("BISG") methodology, which combines geography and surname information into a single proxy probability for race and ethnicity. As has been publicly noted, the CFPB uses public information from the U.S. Census Bureau to construct its surname and geography analyses.

BISG Probability Analysis. Once the CFPB receives an institution's applicant information, it standardizes and matches applicant surname information with Census surname information. For matched applicant surnames, the CFPB constructs a probability ("surname probabilities"), based on the percentage of individuals who identify as being a member of a given race or ethnicity for a given surname[4] — *i.e.*, if 90% of individuals identify as Hispanic in the Census surname information, then the probability of the applicants with that surname being Hispanic is 90%. Any applicant whose surname is not matched will be excluded from the CFPB's analysis.

Next, the CFPB standardizes and matches each applicant's address information into geographic areas, such as census block group or census tract, using the Census geographic information ("geocoded addresses"). Those applicant addresses that cannot be mapped

[4] These six race and ethnicity categories include: Hispanic; non-Hispanic white; non-Hispanic Black or African American; non-Hispanic Asian/Pacific Islander; non-Hispanic American Indian and Alaska Native; and non-Hispanic Multiracial.

are excluded from further analysis. Finally, the CFPB combines the surname probabilities with the geocoded addresses to create a probability (a value that is between, or equal to, 0 and 1), which is assigned to each race and ethnicity category found in the Census surname information.[5]

The White Paper states that the CFPB will then use these proxy probabilities in its statistical analysis to identify any potential disparities in lending outcomes, but does not identify how this statistical analysis is conducted. Although the CFPB notes that the use of its proxy methodology is not required, those auto lenders coming within the Bureau's supervisory authority should familiarize themselves with the methodology and identify any risks it reveals, keeping in mind the Bureau's observation that the methodology will continue to evolve over time.

Based on the Bureau's publication of these three materials, it appears that the CFPB intends to utilize its supervisory authority over the auto finance industry in a comprehensive manner, similar to the other consumer financial products and services it has covered through its previous larger participant rules.

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Please do not hesitate to contact us with any questions.

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[5] This probability construction is referred to as the Bayes Theorem, and the White Paper provides a detailed description of the theorem and its application to the CFPB's proxy methodology.