Article

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CFPB Fair Lending Guidance for Indirect Auto Lenders—It's Not Just About Cars

Several weeks ago, the Consumer Financial Protection Bureau ("CFPB") issued a fair lending guidance bulletin ("Bulletin") directed at financial institutions that make indirect automobile loans. While the Bulletin thus far has not attracted widespread public attention, in the intervening period we have reflected at greater length on the Bulletin and its implications in the fair lending arena. In our view, financial institutions of all stripes that are subject to CFPB jurisdiction—and even those that are not—are well advised to study closely the Bulletin and its implications for CFPB fair lending compliance and enforcement activities across the regulatory spectrum, because the Bulletin raises several notable—and potentially troubling—compliance and liability issues.

The Bulletin represents an aggressive approach by the CFPB to the issue of fair lending compliance and enforcement that most definitely is not limited in its impact to indirect auto lenders. The Bulletin proposes significant interpretations of Regulation B, which implements the Equal Credit Opportunity Act ("ECOA"), without following the Administrative Procedure Act ("APA"), which applies to federal agency rulemakings. Further, the guidance contradicts numerous pronouncements from CFPB officials that the CFPB intends to create a level playing field for all market participants,[1] as the Bulletin claims not to apply to "small" lenders that are not subject to direct CFPB supervision, yet are otherwise subject to the ECOA and its implementing Regulation B. In addition, the Bulletin revives a controversial theory of disparate impact liability that private litigants and the Department of Justice ("DOJ") began advancing in the late 1990s, raising a question of whether lenders and dealers should expect a second wave of government enforcement and private litigation actions. In turn, lenders affected by this Bulletin would do well to reexamine and, as necessary, modify their pricing practices.

Overview of the CFPB's Fair Lending Guidance

The Bulletin sets forth the CFPB's understanding of the indirect automobile lending industry, with a specific focus on the practice whereby a lender allows a dealer to set, within certain parameters, a consumer's interest rate and obtain a share of the payments (identified by the CFPB as "reserve" or "participation"). Such a pricing approach is recognized by the CFPB as a way of compensating dealers for the "value they add by originating loans and finding financing sources." The CFPB notes that its supervisory experience confirms that several indirect automobile lenders have established policies that permit dealer partners to engage in this type of "reserve" or dealer discretionary pricing practice.

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[1] For example, in a March 2013 speech to the Independent Community Bankers of America, CFPB Director Richard Cordray noted that "the Consumer Bureau was working to level the playing field between banks and nonbanks." A year earlier, in a March 2012 speech to the Consumer Bankers Association, Director Cordray stated that "we are doing this by promoting transparency, lowering consumer risks, and ensuring a level playing field between banks and their non-bank competitors." Other officials have made similar remarks about the CFPB's mission to create a level playing field, including Raj Date to the House Financial Services Subcommittee on Financial Institutions and Consumer Credit, and Kelly Thompson Cochran of the CFPB's Office of Regulations to the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity.

The Bulletin expresses the CFPB's belief that allowing motor vehicle dealers to engage in discretionary markups creates a significant risk that loan pricing disparities will occur on a prohibited basis such as race, color, religion, national origin, sex, marital status or age. Further, the CFPB cautions that indirect lenders will be viewed as participants in any discriminatory pricing by dealers due to their role in the auto loan credit decisioning process. The CFPB supports this view by noting that the ECOA, which prohibits discriminating against credit applicants on a prohibited basis, applies to "creditors," which includes any assignees of an original creditor that participate in a decision to extend credit. The Bulletin provides specific examples of indirect lenders participating in the credit decisioning process, thereby becoming ECOA "creditors." These examples include lenders evaluating applicant information to establish a "buy rate" and lenders providing rate sheets to dealers, both of which are established practices in the indirect auto lending market. While the CFPB notes that some indirect lenders have no participation in the credit process, the Bulletin's examples appear to relate to even the most basic pricing and marketing functions of indirect lending.

To address potential fair lending violations, the CFPB suggests that lenders that continue to offer discretionary pricing take steps to ensure they are complying with the ECOA and Regulation B. One approach suggested is for lenders to impose controls on dealer markup and compensation policies. Those lenders also are advised to monitor and address the effects of those policies. However, the guidance fails to provide any suggestions on how lenders can actually monitor the effects of such policies, or how often monitoring should occur in order to demonstrate compliance. The CFPB's other suggestion is for lenders to forgo discretionary dealer pricing altogether and instead pay dealers a flat fee per transaction. The CFPB makes these suggestions despite the Bulletin's statement that dealers add value, and without considering the possibility that pricing differences on indirect loans might be a function of the amount of work done by a dealer to originate a loan.

The Bulletin, however, has implications that extend well beyond its primary audience of indirect auto lenders. We consider below some of these implications.

CFPB Guidance to Mitigate Fair Lending Risk Is Based on New Interpretations

The Bulletin introduces new interpretations of the ECOA and Regulation B that are not clearly derived from the text of Regulation B or its commentary. As a result, the CFPB guidance implicitly suggests that a lender can be liable for a dealer's discriminatory practices even if the lender had no actual knowledge of those practices. The Bulletin suggests this by interpreting what is, at best, an ambiguous provision in Regulation B Section 1002.2(*l*), which states that a person shall not be considered a 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." With a sleight of hand that suggests the meaning of this provision has always been clear, the CFPB simply states that some indirect auto lenders "may be operating under the incorrect assumption that they are not liable under the ECOA for pricing disparities." The CFPB proceeds to directly opine on Section 1002.2(*l*) by stating:

> This provision limits a creditor's liability for another creditor's ECOA violations under certain circumstances. But it does not limit a creditor's liability for its own violations — including, for example, disparities on a prohibited basis that result from the creditor's own markup and compensation policies.

The Bulletin suggests that these types of ECOA violations may be proved through disparate treatment or disparate impact theory. However, disparate impact requires statistical data to identify disparities against a protected class, and the Bulletin does not explain the type of data review that would be required to identify these disparities. The Bulletin also suggests that a lender's markup and compensation policies may, by themselves, trigger liability under the ECOA if the lender regularly participates in the credit decision.

While indirect auto lenders are the ostensible audience for these cautionary remarks, the significance of the Bulletin lies primarily in the fact that the CFPB's views expressed in the Bulletin would not apply solely to auto lenders, but would be highly relevant to just about all classes of consumer lenders that must comply with the ECOA.

Ignoring the Rulemaking Process Creates Legal Uncertainty for All Lenders

Frequently, agencies publish guidance for comment when addressing significant policy actions.[2] The CFPB has bypassed this critical stage, presumably because it has cloaked its interpretation as "guidance" rather than as a formal rule. However, publishing guidance avoids transparency and discussion of the issue, doing the CFPB and the public a disservice. As a result, the public, including lenders, dealers, and consumers, have not had an opportunity to express their views on what the CFPB's fair lending interpretation means in practice, nor have they had an opportunity to pose questions related to the standard's application. There also does not appear to be an implementation period for creditors to conform their activities to the new standard, as the CFPB opted to issue guidance instead of a formal rule.

The Guidance Creates an Uneven Playing Field Among Lenders

The Bulletin notes that it applies to both "depository institutions and nonbank institutions" that are within the CFPB's jurisdiction, even though the CFPB has yet to formally extend its supervisory jurisdiction to nonbank auto lenders. However, the Bulletin does not impose the same compliance challenges on those banks, credit unions and finance companies that are subject to the ECOA and Regulation B but not otherwise large enough to fall under the CFPB's primary supervisory jurisdiction. That is because the interpretation was not issued as a formal rulemaking, which would impose requirements on all creditors subject to the ECOA. By indirectly regulating the conduct of auto dealers, the Bulletin also appears to usurp authority from the Federal Reserve Board of Governors, which has sole authority to amend Regulation B with respect to auto dealers.

The Guidance Suggests Any Industry Can Become Subject to the CFPB's Broad Authorities

Interestingly, the Bulletin illustrates the broad authorities granted to the CFPB by Congress through Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), and demonstrates the creativity of the CFPB's attorneys in exercising those authorities to reach conduct they believe harms consumers. The guidance, for example, represents a novel workaround to the statutory prohibition against direct CFPB regulation of auto dealers contained in Section 1029 of the Dodd-Frank Act.[3] The CFPB has previously reached through lenders to regulate third parties, such as service providers, based on statutory authority. However, by requiring indirect lenders to police the reserve pricing practices of their dealer partners, the CFPB is in effect reaching through banks and other financial services providers to regulate the exact automobile loan pricing practices of dealers that Congress expressly prohibited the CFPB from regulating.

The Bulletin Advances Concepts that Have Been Inconsistently Applied by the Courts

Despite questions surrounding the viability of disparate impact claims brought under the ECOA, the fair lending standards expressed in the CFPB's Bulletin appear to mirror arguments that have been used by the United States DOJ and private litigants to enter into settlements with lenders and auto dealers.[4] The Bulletin's primary concept—that lenders are liable for a dealer's discriminatory actions based on a policy that permits discretionary

[2] *See, e.g.*, Proposed Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249 (Dec. 29, 2005) *and* Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (Mar. 8, 2007).
[3] Save for a few exceptions for non-auto-related financial services, Section 1029 of the Dodd-Frank Act prohibits the CFPB from exercising any "rulemaking, supervisory, enforcement or any other authority" over motor vehicle dealers.
[4] For a list of recent fair lending actions against auto lenders and dealers by the DOJ, see http://www.justice.gov/crt/about/hce/caselist.php#lending. For examples of recent private fair lending actions against lenders and dealers, see the National Consumer Law Center's case index http://www.nclc.org/litigation/case-index-closed-cases.html.

pricing—appears to come directly from arguments that the DOJ filed in an *amicus curiae* brief supporting the plaintiffs in *Cason v. Nissan Motor Acceptance Corp.* in July of 2000.[5] In *Nissan*, plaintiffs alleged that their auto dealer discriminated against African-Americans on a prohibited basis, and that Nissan was equally liable under the ECOA due to its permissive policies allowing dealers to engage in such discriminatory actions.[6]

The DOJ's *amicus* brief specifically asserted that Nissan exercised "complete control over the method of setting interest rates for its borrowers," and that the dealers merely "set rates in strict conformity to [Nissan's] policies."[7] The DOJ argued that, because Nissan "designed and implemented the very system that quite predictably resulted in the alleged discriminatory conduct by dealers," Nissan was liable as a principal that benefited from the discriminatory actions.[8] The DOJ also argued that Nissan could have established policies for dealer pricing that would have prevented illegal bias, or monitored for racial disparities in the loan terms finalized by Nissan dealers.[9] The case was ultimately settled in June of 2003.[10]

Since *Nissan*, private litigants and the DOJ have brought several other actions relying on disparate impact theory to allege that dealers and lenders have priced auto loans on a discriminatory and prohibited basis.[11] Because most of these actions have been settled by consent, however, this theory of liability has not been judicially reviewed. Settlements such as the one entered into by Nissan also call the CFPB's guidance into question, as Nissan agreed to a cap on discretionary dealer pricing as a way to address the issue.

At the same time, new legal precedent established since the last wave of class actions against indirect lenders and dealers may provide some additional procedural defenses for lenders from class action fair lending claims, particularly with respect to the use of loan data to support such claims. In the mortgage fair lending space, regulators and plaintiffs' attorneys are able to mine Home Mortgage Disclosure Act ("HMDA") data to support allegations that a lender's policies have led to a disparate impact against a protected class. However, there is no HMDA equivalent in the auto loan industry, creating a significant impediment for those who seek to prove a borrower is even a member of a protected class. Further, it is unclear what specific data pool regulators or plaintiffs' attorneys might review in order to attempt to identify disparities. In light of the U.S. Supreme Court's decisions in *Wal-Mart Stores, Inc. v. Dukes*[12] and *Comcast Corp. v. Behrend*,[13] which effectively make it more difficult for plaintiffs to demonstrate the commonality of interests necessary to obtain class action certification, these data issues could present significant obstacles to a class-wide recovery.

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[5] DOJ Brief, http://www.justice.gov/crt/about/hce/documents/nissan1.php.
[6] *See generally Cason v. Nissan Motor Acceptance Corp*., 28 Fed. Appx. 392 (6th Cir. Tenn. 2002).
[7] *See* DOJ Brief.
[8] *Id*.
[9] *Id*.
[10] *See* http://www.nclc.org/images/pdf/litigation/closed/nmac_pr.pdf.
[11] *See United States v. Nara Bank*, 2010 U.S. Dist. LEXIS 78918 (C.D. Cal. May 28, 2010) (where Nara Bank agreed not to reenter the indirect auto lending business after allegations that loan terms offered to non-Asian borrowers, many of whom were Hispanic, had significantly higher rates than those terms offered to Asian borrowers); *United States v. Compass Bank*, No. CV 07-B-0102-S (N.D. Ala. Feb. 21, 2007) (where Compass Bank agreed to reform its dealer financing program after allegations that Compass discriminated against borrowers by distributing rate sheets indicating non-married co-signers should pay a higher interest rate); and *United States v. Pacifico Ford*, No. CV 07-03470 (E.D. Pa. Aug. 28, 2007) (where a dealership agreed to implement a uniform system of discretionary pricing after allegations that African-American borrowers disproportionately received loans with higher interest rates); *compare with United States v. Union Auto Sales, Inc.*, No. CV 09-7124 RGK(JCx) (C.D. Cal. Mar. 18, 2010) (first amended complaint where defendant has appealed the government's allegations of disparate impact and litigation remains ongoing).
[12] 564 U.S. __ (2011).
[13] In *Comcast Corp. v. Behrend*, the Supreme Court held that a putative class action plaintiff must offer credible evidence of damages applicable on a class-wide basis before the district court can certify a class under Federal Rule of Civil Procedure 23(b)(3). *See* 569 U.S. __ (2013).

What Comes Next: Compliance Suggestions for Indirect Auto Lenders and Others

Based on the CFPB's guidance, indirect auto lenders may wish to reduce the amount of discretion dealers are permitted to exercise as part of the lending process, inasmuch as the exercise of discretion in lending decisions is a frequent aspect of successful discrimination claims. As a first step in that process, indirect auto lenders should consider a thorough review of their policies and procedures to identify all instances of dealer discretionary pricing. Next, indirect auto dealers should consider revising their policies and procedures to reduce and place controls on dealer discretion, as an effective redesign will serve to create a strong framework from which to monitor and police dealer actions. Updated policies and procedures also will allow indirect lenders to demonstrate they are proactively complying with the CFPB's Bulletin in advance of their next regulatory examination and provide them with a head start on compliance with any future formal rulemakings.

As part of a revised set of policies and procedures, indirect auto lenders may wish to adopt a practice from the mortgage industry and perform their own regular regression analysis to identify statistically significant disparities. Regression analysis has become a standard tool used by mortgage lenders to identify areas that may be viewed as having increased fair lending risk and remediate issues in advance of examinations or regulatory orders. Mortgage lenders also have been able to use regression analysis to identify non-discriminatory factors that might explain a disparity. In other circumstances, mortgage lenders have used the results from their regression analysis to educate regulators and persuade them to limit the scope of a fair lending inquiry.

But it is not indirect auto lenders alone that need to review and adjust their ECOA compliance procedures. Any lender that is subject to the ECOA—but most particularly those lenders that are under the direct jurisdiction of the CFPB—would be well advised to study this guidance and assess the potential impact on its ECOA/fair lending compliance policies and activities. The CFPB plainly is seeking to stake out an aggressive position on fair lending liability by, among other things, seeking to hold lenders legally responsible for the pricing decisions of their independent correspondents. In this regard, the agency's focus on the potential liability implications of third-party discretion raises clear red flags for lenders across the board, and bank and nonbank lenders alike would be well advised to heed and respond to the CFPB warnings embedded in the Bulletin.

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