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How the Consumer Financial Protection Bureau Ensnared Auto Dealers

CFPB

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The Birth of the CFPB

In the summer of 2009, President Obama sent Congress his proposal to create the Consumer Financial Protection Bureau ("CFPB" or "Bureau"). At the time, 11 different federal agencies were charged with overseeing consumer protection laws on financial products, but consumer protection was a second- or third-tier priority. Obama and other proponents felt that some agency must have consumer protection of financial products as its sole mission. Critically, this idea was bipartisan. Even before the 2008 crash, President George W. Bush's secretary of the Treasury, Henry Paulsen, had proposed the concept. And when Republicans in Congress offered their alternative proposals on financial reform, they too proposed establishing a financial product watchdog agency. As Democrats and Republicans agreed in concept regarding a watchdog agency, the debate would focus on the power and independence of the agency. How would its leadership be structured? How would it be funded? How would it interact with other agencies? And most importantly, what activities would it be chartered to regulate?

For an entire year after Obama submitted his plan, the House and Senate asked those very questions. Many in Congress wanted a single director, while others believed a commission of five or more individuals would work best. Some wanted the new agency to be funded annually by Congress. Those seeking to limit CFPB's power wanted it to be subject to review by the Department of Treasury and prudential regulators. All the debate in Congress about whether to create a strong CFPB or a weak CFPB were decisively won by the strong CFPB advocates. Instead of a commission, the Bureau would be headed by a single director who can only be removed for cause. Further insulating the Bureau from legislative oversight, the Bureau is entitled to 12 percent of the Federal Reserve's annual revenue for funding. For the CFPB, there were no purse strings for Congress to hold.

Furthermore, only one federal agency could exert influence over the CFPB. In the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress established the Financial Stability Oversight Council. The FSOC is comprised of 15 federal executives from financial agencies whose job it is to monitor systemic trends in the financial realm. The FSOC alone could overrule a CFPB regulation, but only if it threatens the safety and soundness of the financial system, a high bar to leap. Moreover, overriding a CFPB regulation requires a two-thirds vote. But of the 15 members of FSOC, only 10 are voting members. And of those 10, one is the director of the CFPB himself, who surely won't go against his own work. So, in practice, a rule must be overridden by seven of the nine remaining voting members of the FSOC.

The Creation of Section 1029

The gestation and birth period for the CFPB was also an awful time for the U.S. auto industry. Two icons, General Motors and Chrysler, had suffered the humiliation of sitting before congressional committees asking for a $50 billion bailout or face bankruptcy. Ford too, though not seeking federal relief at the time, was barely holding on. So when the industry began getting back on its feet in late 2009 and 2010, the prospect of a new financial protection bureau to promulgate new regulations to protect Americans from unseen "tricks and traps" of car loans was terrifying. And in the eyes of the auto dealers, they were one of the first targets.

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For auto dealers, the most pressing concern was what the Bureau would regulate. Originally the auto industry had hoped the Bureau would only regulate large, deposit-taking institutions. As the legislative process unfolded, it was clear the CFPB would have a broader scope. What was unclear, however, was whether auto dealers themselves would fall under it. In the face of this uncertainty, instead of selling cars, the industry began to sell Congress on providing dealers an exemption from the regulations of the new Bureau. This began the roller coaster ride for auto dealers. The bill as first introduced did not exempt auto dealers. In fact it exempted no industries. An army of 17,000 dealerships began to engage, flying to D.C. to convince their local congressmen on the committee to support Main Street. Their work paid off, and then-chairman of the Financial Services Committee Barney Frank wrote a carve-out for auto dealers into a second draft. Ultimately the exemption was preserved as the bill passed out of the House.

So, while the protection of Section 1029 seemed to exempt auto dealers from CFPB scrutiny, as often happens with federal law, there was an exception to the exemption.

But the Senate was another story. Senate author Christopher Dodd highlighted a list of alleged abuses some auto dealers had committed which justified their need for regulation. But the same army which was successful in the House mobilized in the Senate. Sen. Sam Brownback of Kansas was poised to introduce an exemption for auto dealers which mirrored the one in the House. Brownback's amendment threatened to derail the whole bill. Brownback's amendment was so delicate that the president himself weighed in on this single issue, a rarity for presidents. Obama opposed the exemption, claiming that it would undermine efforts to combat the very tricks and traps the agency was designed to prevent. Despite this, the House and Senate agreed with their local car dealers, and more than a year after President Obama submitted the CFPB plan to Congress, the new law was enacted with Section 1029, excluding auto-dealers from any rulemaking authority at the CFPB.

Good Fences Can Have Holes: CFPB Uses Lending to Indirectly Regulate Auto Dealers

While the CFPB cannot directly regulate auto dealers, the CFPB has great latitude in combating unfair, deceptive and abusive activities in providing consumer financial products or services. The law explicitly states it covers the mortgage field, student loans and financial institutions with more than $10 billion in assets. Moreover, other businesses can be subject to the CFPB if they issue consumer credit of any kind and engage in conduct which endangers consumers. As a result, no business which offers credit to consumers is guaranteed safety from CFPB.

So, while the protection of Section 1029 seemed to exempt auto dealers from CFPB scrutiny, as often happens with federal law, there was an exception to the exemption. Auto dealers were subject to CFPB regulations if they provided non-auto credit or if they routinely use an affiliated third-party financing source to provide credit to the car buyer. In short, if a GM dealership routinely uses GMAC, or a Honda dealership routinely uses Honda Financial, they fall under the CFPB umbrella. Though Congress gave CFPB a foothold to regulate auto loans with the limited exclusion, initially the CFPB focused its resources on payday lenders, debt collectors and mortgage brokers. However, in 2012 the CFPB expanded its reach beyond large banks and began to focus on the auto finance/lending industry (and the consumer complaint portal on CFPB's website was expanded to include auto loans). At the same time, the CFPB began accessing the Federal Trade Commission (FTC) and databases of state attorneys general for additional auto finance complaints.

In January 2013, Rick Hackett, assistant director of the Research, Markets and Regulations Division for the CFPB, spoke to the American Bar Association's Consumer Financial Services Division about “Discretionary Pricing in Indirect Auto Finance,” making clear that the CFPB would be issuing written guidance and rulemaking regarding dealer markups and their disparate impact on minorities. And in March 2013, the CFPB laid out its authority over auto lenders in CFPB Bulletin 2013-02. In the Bulletin, the Bureau warned against the markup practice indicating it could result in different rates on auto loans by similarly creditworthy borrowers and the CFPB would seek to promote a level playing field throughout the auto lending market.

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By October, Congress began to focus on the auto finance industry as members were on both sides of the debate. Some wanted increased action while other took issue with the CFPB's March bulletin. To address these concerns, the CFPB held its auto finance forum on Nov. 14, 2013, in Washington. Director Cordray often used such forums to announce enforcement efforts and used the November forum to argue that certain risk-based pricing models and dealer markups related to auto loans were irreparably flawed as there existed statistically significant disparities in rates paid by Asian, Hispanic and African-American buyers compared to rates paid by whites with similar credit characteristics. In fact, Patricia Ficklin, assistant director of fair lending, stated the Bureau found

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statistically significant disparities in rates exceeding 10, 20, 30 basis points, amounting to tens of millions of dollars in overpayments. As a result, it was announced that the CFPB and DOJ were pursuing a number of joint indirect auto finance investigations (101 BBR 786, 11/19/13).

Analysis of Auto Related Complaints Made to the CFPB

The primary tool that the CFPB uses to identify and address risky trends is its consumer complaint website. As set forth in Dodd-Frank, collecting, investigating and responding to consumer complaints is an integral part of CFPB's work. Though the portal serves as an effective tool for macro-level trend analysis, it is equally intended for micro-level dispute resolution. Through the complaint process, the CFPB hears directly from consumers regarding the challenges they face in the marketplace, brings those concerns to the company's attention and then helps address their complaints. This complaint process allows the CFPB to guide its regulatory activit—supervising companies, enforcing federal consumer laws and updating rulemaking. The CFPB currently accepts complaints about mortgages, bank accounts and services, private student loans, debt collection practices, credit reporting, money transfers and other consumer loans.

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At the time of this writing, of the over 5,000 “other consumer” loan complaints (those not dealing with mortgages, student loans, debt collection, credit reporting, credit cards or bank accounts), the majority of them were auto loans. Judging from actual complaints, consumers are sometimes confused by the difference between dealer-arranged and bank financing. Clearly, many consumers don't realize that similar to the price of the car, the interest charged, regardless of whether the financing is arranged by the dealer or bank, is negotiable. Moreover, risk-based pricing models — where lenders offer different consumers different interest rates based on an estimated risk that the loan may not be paid back — seem to lack the transparency the Bureau desires.

Implications for Future Auto Dealer Litigation, Regulation

The controversy surrounding auto dealers and fair lending concerns is best explained by a March 30, 2013, comment from the Center for Responsible Lending to the FTC with respect to dealer markups. Per the Center, buyers who bought cars in 2009 paid $25.8 billion in interest over the lives of their loans due to dealer markup; however, in their view, buyers had limited chances to negotiate the price of the loan and were unaware that dealers are compensated through the financing and not just the sale. Per the Center: “This creates a perverse market incentive where the dealer's incentive is to sell the loan that provides the most compensation for the dealer, which by definition is not the loan that provides the most competitive rate for the consumer.” The question then becomes, who can the CFPB hold liable for the results for any perverse incentives as the CFPB has no direct authority over auto dealers?

The answer to that question is becoming clear: the CFPB intends to use its authority over financial institutions to regulate auto dealers. The March 21, 2013, Bulletin, (Indirect Auto Lending Compliance with the Equal Credit Opportunity Act) made clear that the CFPB believes that allowing auto 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; moreover, the CFPB made clear that lenders will be viewed as participants in any discriminatory pricing by dealers due to their role in the auto loan process. To that end, the CFPB advised lenders to impose greater controls upon dealers to monitor dealer financing activity (100 BBR 545, 3/26/13). One suggested method of exerting control has been for dealers to eliminate discretionary pricing and instead adopt a flat fee model. However, this model ignores the value a dealer brings to a consumer by identifying various financing options and the amount of work a dealer must do in order to actually originate a loan for a consumer.

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Though direct connections between the complaint database and enforcement actions are not always clear, a recent action was filed against Ally Financial resulting in a consent order resolving allegations that Ally's dealer compensation resulted in higher dealer markup loans to Hispanic, African-American and Asian/Pacific Islander, Ally agreed to pay $80 million to consumers and an $18 million civil penalty. Ally further agreed to conduct ongoing monitoring of dealer markup disparities and provide payments to affected consumers based upon the analysis. Coordinating with the Department of Justice, the Ally action was CFPB's first major fair lending enforcement action, but it is clear through implication and action that the Bureau intends to use this club to regulate auto dealers (101 BBR 1014, 12/24/13).

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The CFPB's efforts are a clear power-grab into an area that was specifically exempted by the statutes that created it. In taking this action, the CFPB has cloaked its self-created authority as “guidance” rather than a formal rule – bypassing the typical regulatory comment period which is essential to vet and analyze legal and practical issues. The Bulletin's primary concept—that lenders are liable for a dealer's discriminatory actions based on a policy that permits discretionary pricing—is very similar to Department of Justice arguments set forth in an amicus curiae brief supporting the plaintiffs in *Cason v. Nissan Motor Acceptance Corp.* in July of 2000. This action, like many others, was ultimately settled, preventing the legal underpinnings of the theory from being tested by the court.

Critically, the CFPB's theories are based upon their interpretation of statutory and regulatory authority – not the law written by Congress. However, the Supreme Court of the United States specifically rejected this tactic in *Freeman, et al. v. Quicken Loans, Inc.*, 132 S. Ct. 2034 (2012). In that case, the entire court ruled that administrative agencies cannot expand federal consumer protections beyond the express terms enacted by Congress. Freeman examined whether the Department of Housing and Urban Development's regulatory interpretation of certain Real Estate Settlement Procedures Act provisions trumped actual statutory language (in that case, how some fees were divided). Speaking with one voice, the court held that “vague notions of statutory purpose provide no warrant for expanding [the disputed] prohibition beyond the field to which it is unambiguously limited: the splitting of fees paid for settlement services.” Tellingly, the court rejected both HUD's and the CFPB's attempts to read more into the statute than Congress intended.

Going forward, lenders and auto dealers can expect additional (and likely, extensive) regulatory guidance and enforcement activity. And, similar to the mortgage market, this pressure may force lenders to explore alternatives to dealer participation, most likely in the form of flat-fee arrangements. Despite potential flaws in the legal underpinning of the CFPB's strategy, regulatory scrutiny from the CFPB is expected to increase regulatory costs and compliance requirements for lenders – and indirectly auto dealers – are expected to continue to weigh on operations for the foreseeable future.

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