Automobile Supervision and Enforcement – Regulatory Actions and CFPB Proposed Rule

Executive Summary

The automobile finance industry is under heightened regulatory scrutiny that is resulting in various enforcement actions against automobile lenders requiring significant payments of restitution and civil money penalties. Some regulators, including the Consumer Financial Protection Bureau ("CFPB" or "Bureau") and the Department of Justice ("DOJ"), have been particularly focused on fair lending risks associated with discretionary pricing policies. In 2013, the CFPB issued Bulletin 2013-02 – *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act* - to provide guidance to those bank and nonbank indirect auto lenders within its jurisdiction regarding the risks associated with dealer mark-ups and discretionary pricing policies. More recently, the CFPB published a *Supervisory Highlights* report, in which it summarized the Bureau's fair lending supervisory activity with respect to the indirect automobile lending market along with a White Paper detailing the proxy methodology it uses to analyze a lender's application data for fair lending compliance.[1] The CFPB guidance suggests eliminating or significantly limiting discretionary pricing practices may control fair lending risks related to pricing disparities.

The Office of the Comptroller of the Currency's (OCC) Fall 2014 *Semiannual Risk Perspectives* report highlighted loosening underwriting standards and increased layering of risk related to direct and indirect auto lending as contributing to an overall increase in credit risk in the banking sector. The agency indicated that it will focus heightened supervisory attention on underwriting practices for indirect auto lending as part of its large bank as well as community and midsize bank supervision.

Other areas of regulatory attention include auto lenders': compliance management systems, marketing practices, other pricing and fees (including Fair Lending Analytics), collections and servicing practices, servicemember protections, credit bureau reporting, and unfair, deceptive, or abusive acts or practices ("UDAAP"[2]) compliance.

In September 2014, the CFPB published a proposed rule that would expand the Bureau's supervisory oversight of the automobile finance industry to include nonbank automobile finance companies that qualify as "larger participants" of an automobile financing market, as defined by the CFPB.

[1] *Supervisory Highlights: Summer 2014*, released September 17, 2014, and *Using publicly available information to proxy for unidentified race and ethnicity*, released September 17, 2014.
[2] The Federal Reserve Board, OCC, and Federal Deposit Insurance Corporation may enforce violations of the prohibitions on unfair or deceptive acts or practices ("UDAP") under Section 5 of the *Federal Trade Commission Act*.

Background

The CFPB estimates[3] the proposed automobile financing market encompasses more than five hundred nonbank automobile lenders. Of these lenders, approximately 90 percent of the automobile loan and lease transactions are conducted by fewer than 40 entities. The entities are comprised of "captives" (generally subsidiary finance companies owned by auto manufacturers that provide consumers with financing for the primary purpose of facilitating their parent companies' and associated franchised dealers' auto sales), "Buy Here Pay Here" ("BHPH") finance companies (the CFPB states that BHPH finance companies are similar to captives as they are associated with certain BHPH dealers, which traditionally focus on subprime and deep subprime borrowers), and specialty financial companies.

Automobile loans may be financed directly, where consumers seek credit directly from a lender, or indirectly, where an auto dealer typically facilitates a loan from a third party. Banks, credit unions, and nonbank automobile finance companies provide credit to consumers both directly and indirectly. The CFPB states that captives and specialty finance companies are more active in the indirect financing channel. The Bureau adds that roughly 80 percent of consumers who finance the purchase of an automobile use the indirect channel and look to auto dealers to facilitate their purchase loans. Some indirect auto lenders have policies that permit auto dealers to mark-up lender-established rates and this difference in rates is then used to compensate the dealer.

The CFPB has previously provided guidance to indirect auto lenders (CFPB Bulletin 2013-02, March 2013) to caution them about the risks associated with dealer mark-ups and discretionary pricing policies, including fair lending compliance under the *Equal Credit Opportunity Act* (ECOA) and its implementing regulation, Regulation B. The guidance also includes features of a strong fair lending compliance program.

The CFPB has supervisory authority over large depository institution auto lenders (direct and indirect) and has proposed to supervise certain nonbank automobile financing companies. It has previously identified four markets for nonbank supervision pursuant to Section 1024 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act), which, in addition to granting the CFPB authority to supervise certain nonbank providers of consumer financial products and services regardless of size (including mortgage companies, payday lenders; and private education lenders), grants the CFPB authority to supervise "larger participants" of markets for consumer financial products and services that the CFPB identifies and defines by rule. These markets, and the related "larger participants" criteria, include:

- Consumer debt collection (debt collectors with more than $10 million in annual receipts from debt collecting activities);
- Consumer reporting (companies that receive more than $7 million in annual receipts from consumer reporting activities);
- Student loan servicing (nonbank student loan servicers that handle more than one million borrower accounts, including both Federal and private student loans); and
- International money transfers (companies that conduct at least one million international money transfers annually).

[3] CFPB proposed rule page 27.

Description

Bank and nonbank automobile finance companies have been subject to heightened regulatory scrutiny and, in some cases, enforcement actions. Highlights of the public actions taken by the CFPB, DOJ, and the Federal Trade Commission ("FTC") follow.

Actions Related to Discretionary Loan Pricing

In November and December of 2014, two large captive (nonbank) automobile finance companies announced in separate public filings that they had been notified by the CFPB and the DOJ (collectively, "Agencies") that the Agencies are prepared to initiate enforcement actions against the companies to address the Agencies' findings that the companies' business practices related to dealers resulted in loan pricing disparities to certain consumers "in contravention of applicable laws." The companies each stated the Agencies have indicated they are seeking monetary relief and implementation of changes to the companies' discretionary pricing practices and policies. However, they also stated that should they work voluntarily with the Agencies to resolve the allegations, the Agencies may defer pursuit of any litigation. Both companies note that changes to their discretionary pricing practices and policies could "adversely affect" their businesses.

In December 2013, the CFPB entered into a consent order with a large bank operating as an indirect auto lender to address its findings that the bank "engaged in a pattern or practice of lending discrimination" in violation of the ECOA, which prevents creditors from discriminating against loan applicants in credit transactions on the basis of characteristics such as race and national origin. Based on an investigation conducted in coordination with the DOJ, the CFPB concluded the bank's discretionary pricing practices enabled and incentivized dealers to charge certain groups of borrowers higher mark-up rates (resulting in higher interest rates) than other similarly-situated borrowers. Further, the CFPB stated it found the bank "failed to implement an effective compliance program to monitor its portfolio for discrimination."

The consent order required the bank to pay $18 million in civil money penalties and restitution of $80 million. In addition, among other things, the bank was required to monitor fair lending risks of ongoing dealer markups. Such monitoring, however, would not be required if the bank were to implement a non-discretionary dealer compensation structure.

These measures are consistent with the guidance in CFPB Bulletin 2013-02 (March 2013), which cautions institutions under CFPB jurisdiction, including indirect auto lenders, to ensure they are operating in compliance with the ECOA and Regulation B with regard to dealer mark-up and compensation policies (i.e., discretionary pricing policies) by: imposing controls and monitoring procedures to address unexplained pricing disparities on a prohibited basis; or eliminating dealer discretion to mark-up borrowers' interest rates. Similarly, in its September 2014, *Supervisory Highlights* the CFPB stated that through multiple supervisory reviews the Bureau found cases where indirect auto lenders' discretionary pricing policies have resulted in discrimination and that fair lending risks were not adequately monitored or controlled. These lenders were directed to "pay remediation sufficient to address direct and indirect consumer harm" as well as to "establish and maintain strong compliance management to prevent, detect, and remediate future disparities in pricing on prohibited bases" to the extent they choose to maintain discretionary pricing policies. The CFPB suggests significantly limiting the magnitude of discretionary pricing adjustments may reduce or effectively eliminate pricing disparities.

Other Regulatory Actions

The CFPB publicly announced two additional enforcement actions during 2014 that relate to nonbank automobile finance companies:

- In November, a BHPH (i.e., Buy Here Pay Here) dealer entered into a Consent Order with the CFPB to address debt collection activities the CFPB identified as unfair acts and practices in violation of the CFPB's UDAAP provisions. The Consent Order also addresses credit reporting activities that were identified by the CFPB as violating the *Fair Credit Reporting Act* (FCRA), including: furnishing information to consumer reporting agencies that the dealer had reasonable cause to believe was inaccurate; failing to correct or delete inaccurate information within a reasonable time after learning of the inaccuracies; and, failing to establish and/or implement reasonable written policies and procedures regarding the "accuracy" and "integrity" of the information the dealer furnished to consumer reporting agencies. Without admitting or denying any of the findings of fact or conclusions of law, the dealer agreed to pay $8 million in civil money penalties as well as take actions to provide corrected information to credit reporting agencies and to implement a process for auditing information provided to credit reporting agencies and monitoring disputes received.
- In August, the CFPB took action against an auto finance company to address the CFPB's findings the company violated the FCRA. The CFPB found that the company furnished inaccurate information about its customers to credit reporting agencies for an extended period of time and did not take steps to correct the reported inaccuracies or the system creating the inaccuracies once discovered.

In December 2014, the FTC announced that it had taken enforcement actions against two separate auto dealerships for violations of FTC Administrative Orders that prohibit the companies from deceptively advertising the cost of buying or leasing an automobile. One company agreed to pay $360,000 in civil penalties to settle the FTC's charges that it violated the Administrative Orders by "frequently focusing on only a few attractive terms in their ads while hiding others in fine print, through distracting visuals, or with rapid-fire audio delivery." The FTC charged the second company with misrepresenting the costs of financing or leasing a vehicle by concealing important terms of the offer as well as failing to clearly and conspicuously make credit disclosures as required by the *Truth-in-Lending Act* ("TILA") and failing to retain and produce appropriate records to the FTC to substantiate its offers.

Also in December 2014, the FTC announced that it had reached an agreement with an auto dealer to settle the agency's charges the dealer used deceptive practices to promote the sale and lease of vehicles. The FTC charged the deceptive practices as violating the UDAP provisions of the FTC Act, as well as the *Consumer Leasing Act* (CLA) and the TILA, and the implementing regulations to those laws.

Proposed Rule - Larger Participants of an Auto Financing Market

The CFPB has proposed a rule that would expand the Bureau's supervisory oversight of the automobile finance industry to include certain nonbanks. As proposed, the CFPB would define a market for automobile financing that would include:

- Grants of credit for the purchase of an automobile, refinancings of such credit obligations, and purchases or acquisitions of such credit obligations (including refinancings); and
- Agreements to lease an automobile and purchases or acquisitions of such automobile lease agreements.

Test to Define Larger Participant

Larger participants of this automobile financing market would include nonbank companies that, together with their affiliate companies, completed at least 10,000 aggregate annual loan and lease originations (as defined in the proposed rule) in the preceding calendar year. The annual originations of an affiliate must be aggregated with the annual originations of the nonbank company, even if the affiliate relationship was not in effect for the entire calendar year.

Motor vehicle dealers that are excluded from the Bureau's authority by Section 1029 of the Dodd-Frank Act would not qualify as larger participants for this larger participants rule. The proposed rule would also exclude additional motor vehicle dealers that are not subject to the statutory exclusion – specifically, those motor vehicle dealers that are identified in section 1029(b)(2) of the Dodd-Frank Act and are predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both. This would exclude from the proposed larger-participant rule certain dealers that extend retail credit or leases to consumers without routinely assigning them to unaffiliated third parties.

Definitions

The following definitions would be used to define the automobile financing market:

- "Automobile" - would mean any self-propelled vehicle primarily used for personal, family, or household purposes for on-road transportation. It would include new and used vehicles such as cars, sports utility vehicles, light-duty trucks, and motorcycles. Motor homes, recreational vehicles, golf carts, and motor scooters would be excluded. Heavy-duty trucks, buses, or ambulances and other vehicles designed for and primarily used for commercial purposes also would be excluded from this definition.
- "Annual originations" - would mean grants of credit for the purchase of an automobile, refinancings of such credit obligations and any subsequent refinancings thereof, and purchases or acquisitions of such credit obligations (including refinancings). "Annual originations" would also include "automobile leases" and purchases or acquisitions of automobile lease agreements. Investments in asset-backed securities would be excluded.
- "Aggregated annual originations" - would mean the sum of a nonbank's annual originations and each of the annual originations of the nonbank's affiliated companies. The originations of affiliates would be required to be calculated separately for the entire calendar year and added to the originations of the nonbank no matter whether the affiliate relationship existed for the entire year.
- "Automobile lease" - would mean leases that fall within the meaning of section 1002(15)(A)(ii) of the Dodd-Frank Act (which defines a financial product or service

to include personal property leases that are the functional equivalent of purchase finance arrangements if the lease is on a non-operating basis and has an initial term of not less than 90 days). The CFPB has proposed to add a new section 1001.2(a) to its larger participants rules that would deem an automobile lease to be a financial product or service as long as the lease (1) qualifies as a full-payout lease and a net lease; (2) has an initial term of at least 90 days; and (3) does not meet the requirements for a financial product or service under section 1002(15)(A)(ii).

- "Refinancing" – would mean any grant of credit for the purchase of an automobile that satisfies and replaces an existing credit obligation, even if the nonbank covered person is not the original creditor, holder or servicer of the existing credit obligation.

Market Coverage

The Bureau estimates the proposed threshold would bring approximately 38 nonbank companies within the Bureau's supervisory authority, which represents roughly 7 percent of all relevant nonbank companies in the automobile financing market. Based on the number of covered transactions (10,000 aggregate annual originations), the Bureau estimates these 38 entities are responsible for approximately 91 percent of the nonbank automobile financing market activity and provided loan and lease financing to approximately 6.8 million consumers in 2013.

Commentary

Today's current regulatory climate has elevated the need for change to a new level of compliance It requires consumer financial services providers - banks and nonbanks - to quickly strengthen and enhance their business operational procedures and controls via operational, compliance, and technology transformation.

The CFPB and FTC have a wide range of supervisory and enforcement authority that can be employed to address findings of non-compliance or consumer harm across bank and nonbank providers of consumer financial products and services, including:

- Supervisory discovery and examination with respect to overall compliance programs and controls, as well as specific consumer regulations;
- Investigations or Civil Investigative Demands;
- Civil actions, including restitution and fines;
- Referrals to the Department of Justice; and
- Cease-and desist proceedings.

Notably, banks and nonbanks under CFPB supervision may favorably affect the ultimate resolution of a Bureau enforcement investigation if they engage in "responsible conduct," which the CFPB defines to include proactively self-policing for potential violations, promptly self-reporting to the Bureau when potential violations are identified, quickly and completely remediating the harm resulting from the violations, and affirmatively cooperating with any Bureau investigation above and beyond what is required (refer to CFPB Bulletin 2013-06).

The prudential bank regulators (Federal Reserve Board, OCC, and Federal Deposit Insurance Corporation) each have supervisory authority (examination and enforcement) regarding compliance with the federal consumer financial laws and their implementing regulations for those insured depository institutions under their jurisdiction with total assets of $10 billion or less and the affiliates of those institutions. However, these agencies have highlighted direct and indirect auto lending as contributing to safety and soundness as well as compliance risks and, as such, will be looking more closely at the processes and practices surrounding the extension of automobile credits by depository institutions of all sizes. Such reviews could address the impact of competition from nonbank financial companies (direct and indirect lenders) and may span the spectrum of current regulatory concerns, including fair lending, UDAAP / UDAP, servicing, credit reporting, debt collections, compliance management systems, and complaints management.

In the past, the CFPB has generally required nonbank larger participants to be prepared to meet the CFPB's supervisory expectations within 60 days of the publication of the relevant final rule. As such, nonbank companies that anticipate they would qualify as larger participants of the automobile financing market based on the proposed criteria should begin immediately to prepare for CFPB supervision and examination. In particular, they should:

- Review and assess written policies and procedures to ensure they address:
  - Compliance with the federal consumer financial laws relevant to auto lending including ECOA, EFTA, FACTA, FCRA, FDCPA, and TILA;
  - Prohibitions against UDAAP, including consideration of risks associated with interest rate financing and add-on products (e.g., warranties);
  - Oversight of third-party service providers, such as providers of add-on products, debt collection companies, and repossession companies;
  - Complaints management, including intake and resolution as well as those complaints received indirectly through the CFPB, financial institutions, and social media or through complaints against third-party service providers; and
  - Escalation protocols and corrective actions for non-compliance with such policies and procedures.

- Consider:
  - Conducting a "readiness assessment" of compliance with federal consumer financial laws and implementing regulations, including gap analyses;
  - Becoming familiar with CFPB examination procedures and information requirements, including a compliance management system (CMS), and identifying any related systems and staffing needs to meet those requirements;
  - Reviewing the CFPB fair lending supervisory program and the features identified by the CFPB as contributing to a well-developed fair lending compliance program;
  - Conducting a fair lending review at the portfolio- and dealer-level, including an analysis of discretionary pricing policies and an assessment of potential risks to consumers;
  - Reviewing business strategies, including the discretionary pricing policies (e.g., dealer mark-ups);

- Reviewing staffing requirements and training materials to ensure that consumer compliance and consumer protection issues are adequately addressed for the board of directors, senior management, and other employees; and
- Evaluating the "culture of compliance" to ensure that the board of directors and senior management are committed to compliance with regulatory requirements and the promotion of consumer protection across the enterprise and that compensation programs are consistent with these goals.

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