

Automobile Finance Supervision: CFPB Final Rule for the Nonbank Automobile Financing Market and CFPB Examination Procedures

Executive Summary

The Consumer Financial Protection Bureau (“CFPB” or “Bureau”) currently supervises large banks, thrifts, and credit unions (collectively, “Banks”) engaged in automobile finance as well as their affiliates. On June 10, 2015, the CFPB issued a final rule that expands the Bureau’s supervisory authority to include nonbanks that qualify as “larger participants” of an automobile financing market, as defined by the CFPB. In final form, the rule is substantially similar to the proposed rule released in September 2014 (please refer to KPMG Regulatory Practice Letter 14-22). It will become effective 60 days after publication in the *Federal Register*.

Under the final rule, the CFPB has defined the market for automobile financing to 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.

The “larger participants” of this market are defined to include nonbank companies that, together with their affiliate companies, completed at least 10,000 aggregate annual loan and lease originations 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.

An exclusion from the “larger participants” definition is provided for motor vehicle dealers that are excluded from the Bureau’s authority by Section 1029(b) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”) (i.e., motor vehicle dealers that extend retail credit or retail leases directly to consumers and do not routinely assign those credits or leases to an unaffiliated third party). An exclusion is also provided for those dealers that: meet the statutory definition of a motor vehicle dealer under Section 1029(f); are described by Section 1029(b); and are predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.

The CFPB estimates 34 nonbank financial companies currently meet the criteria for a “larger participant” of the automobile financing market, as defined in the final rule. They further estimate these companies originate 90 percent of the nonbank loan and lease activity.

Definitions

The following definitions apply to the defined automobile financing market:

- “Automobile” - means any self-propelled vehicle primarily used for personal, family, or household purposes for on-road transportation. It includes new and used vehicles such as cars, sports utility vehicles, light-duty trucks, and motorcycles.

The definition of “automobile” excludes motor homes, recreational vehicles, golf carts, and motor scooters, as well as heavy-duty trucks, buses, ambulances and other vehicles designed for and primarily used for commercial purposes.

- “Annual originations” - means:
 - Grants of credit for the purchase of an automobile; refinancings of such credit obligations; any subsequent refinancings thereof secured by an automobile; and purchases or acquisitions of such credit obligations (including refinancings).
 - “Automobile leases” and purchases or acquisitions of automobile lease agreements.

The definition of “annual originations” excludes investments in asset-backed securities, and purchases or acquisitions of obligations by a special purpose entity established for the purpose of facilitating asset-backed securities transactions. The exclusion for special purpose entities was added in response to comments received on the proposed rule suggesting that without the specific exclusion many securitization entities would be considered “larger participants” and that some automobile loans and leases could be double or triple counted.

- “Aggregated annual originations” - means the sum of a nonbank’s annual originations and each of the annual originations of the nonbank’s affiliated companies. The originations of affiliates are required to be calculated separately for the entire calendar year and added to the originations of the nonbank regardless of whether the affiliate relationship existed for the entire year.
- “Automobile lease” – means a lease that falls 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. For these purposes, “non-operating” means the lease provider is not directly or indirectly engaged in operating, servicing, maintaining or repairing the leased property during the lease term.

“Automobile lease” also means a lease that qualifies as a full-payout lease and a net lease, has an initial term of at least 90 days, and does not meet the requirements for a financial product or service under section 1002(15)(A)(ii). This is a new definition of “automobile lease” that will be added to the definitions of a “financial product or service” under Title X of the Dodd-Frank Act (the *Consumer Financial Protection Act*).

- “Refinancing” – means 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.

Examinations

Concurrent with the release of the final rule, the CFPB released Automobile Finance Examination Procedures to be used for the Bank and nonbank entities it supervises. The stated objectives of the examination include:

- Assessing the quality of the supervised entity’s compliance management system for preventing violations of the federal consumer financial laws;
- Identifying acts or practices that materially increase the risk of violations of the federal consumer financial laws and associated harm to consumers;
- Gathering facts that help determine whether a supervised entity engages in acts or practices that are likely to violate federal consumer financial laws; and
- Determining whether a violation of federal consumer financial law has occurred and whether further supervisory or enforcement action is necessary.

The identified federal consumer financial laws primarily applicable to automobile financing activities include the:

- *Truth-in-Lending Act* (TILA) and its implementing regulation, Regulation Z;
- *Electronic Funds Transfer Act* (EFTA) and its implementing regulation, Regulation E;
- *Fair Debt Collection Practices Act* (FDCPA);
- *Gramm-Leach-Bliley Act* (GLBA);
- *Equal Credit Opportunity Act* (ECOA) and its implementing regulation, Regulation B;
- *Consumer Leasing Act* (CLA) and its implementing regulation, Regulation M; and

- Provisions governing prohibitions against unfair, deceptive, or abusive acts or practices (UDAAP).

In addition, the Examination Procedures direct examiners to look for potential violations of laws, such as the *Servicemembers Civil Relief Act* (SCRA), that are not among the federal consumer financial laws transferred to the authority of the CFPB (the “enumerated laws”) and are enforceable by other federal or state regulatory authorities but have a direct relationship to the offer or provision of consumer financial products and services.

Background

The participants of the nonbank automobile financing market defined by the CFPB are comprised of specialty financial companies, “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), and “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).

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 and nonbank automobile finance companies provide credit to consumers both directly and indirectly. The CFPB states that specialty finance companies and captives 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 (generally referred to as discretionary pricing policies and dealer mark-ups).

Pursuant to authority granted by Section 1024 of the Dodd-Frank Act, the CFPB may supervise certain nonbank providers of consumer financial products and services regardless of size (including mortgage companies, payday lenders; and private education lenders) as well as certain “larger participants” of markets for consumer financial products and services that the CFPB identifies and defines by rule. The nonbank automobile financing market is the fifth such market the CFPB has defined. The other four 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).

Section 1024 also gives the CFPB authority to supervise, regardless of size, any nonbank financial services company (including nonbank automobile financing companies) that it has reasonable cause to believe “is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services.”

The prudential bank regulators (Federal Reserve Board, Office of the Comptroller of the Currency, 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. The prudential bank regulators also consider compliance with federal consumer protection laws that are not under the rule-writing authority of the CFPB, such as the SCRA. Importantly, these agencies have highlighted direct and indirect auto lending as contributing to safety and soundness in addition to consumer compliance risks and, as such, should be expected to be looking more closely at the processes and practices surrounding the extension of automobile credits by depository institutions above and below the \$10 billion asset size threshold. 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.

Commentary

The CFPB and the prudential bank regulators continue to look closely at both direct and indirect automobile financing activity and the release of the CFPB's final rule expands the scope of their attentions to include nonbank providers, encompassing a broad array of regulatory issues, including fair lending, UDAAP / UDAP, servicing, credit reporting, debt collections, third parties, compliance management systems, and complaints management.

Notably, any nonbank covered person that qualifies as a "larger participant" under the final rule must remain a "larger participant" until two years after the first day of the tax year in which the "larger participant" last met the qualifying test. Nonbank automobile financing companies that expect they now qualify as "larger participants" of the automobile financing market 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 as well as other consumer protection laws, such as the SCRA;
 - Prohibitions against UDAAP, including consideration of risks associated with advertising and marketing, 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 the CFPB examination procedures and information requirements, including the requirement for 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, and conducting a fair lending review at the portfolio- and dealer-level to include an assessment of potential risks to consumers;
 - Reviewing business strategies, including product offerings, underwriting criteria and discretionary pricing policies;
 - Reviewing auto financing activities across the product life cycle (including product development, marketing, extensions of credit, sales, servicing, complaints intake and resolution, and account termination) to identify potential consumer protection risks, focusing on areas of regulator concern, such as UDAAP prohibitions, payments practices, debt collections and restructuring, repossessions and replevins, and credit reporting;
 - Becoming familiar with regulatory concerns and emerging risks associated with the auto financing market as evidenced by regulatory guidance and related enforcement actions taken by the CFPB, the prudential bank regulators, the Federal Trade Commission, the Department of Justice, and the Department of Defense;
 - 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, senior management and middle 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.

This is a publication of KPMG's Financial Services Regulatory Risk Practice and the Americas Financial Services Regulatory Center of Excellence (CoE).

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