

Statement of the National Automobile Dealers Association
A Hearing Entitled
“Who’s In Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom”
Before the House Financial Services Committee
April 8, 2014

Mr. Chairman, thank you for the opportunity to submit the comments of the National Automobile Dealers Association (NADA) in the hearing record. NADA is a national trade association that represents the interests of 16,000 franchised new car and truck dealer members. NADA members are primarily engaged in the retail sale and lease of new and used motor vehicles, and also engage in automotive service, repairs, and parts sales. Last year America’s franchised new car and truck dealers collectively employed nearly one million individuals and sold or leased approximately 15.6 million new cars and light duty trucks. NADA members operate in every congressional district in the country, and the majority of our members are small businesses as defined by the Small Business Administration.

Overview

The current dealer-assisted financing system provides broad credit availability and low credit prices for consumers. Among other things, an automobile dealer’s ability to “meet or beat” its competitors’ rates produces vigorous marketplace competition that benefits consumers. A majority of car buyers choose to finance their purchases through optional, indirect financing at dealerships.¹

The Consumer Financial Protection Bureau (CFPB or the Bureau) released guidance on March 21, 2013 (the CFPB Guidance), without prior notice or an opportunity for public comment, alleging a “significant risk” that dealer-assisted auto financing has a “disparate impact” on the price of credit for consumers in protected classes. This controversial Guidance pushes auto finance sources into changing the way they compensate dealers to a flat fee approach and, in doing so, threatens to eliminate dealer flexibility to offer consumers a discounted interest rate when arranging auto financing.

The CFPB made this “disparate impact” allegation without providing any supporting public analysis or documentation. Careful study of the CFPB Guidance, however, reveals that the CFPB’s attempt to regulate auto dealers by pressuring lenders to change their business practices (1) does not address the disparate impact problem the CFPB alleges; and (2) will likely raise credit costs and decrease access to credit for consumers. In addition to the harm the CFPB’s new policies will cause consumers, Congress should take notice that the CFPB is bringing about these fundamental and detrimental changes via “guidance,” thus avoiding both the rulemaking process and coordination with the federal agencies that Congress vested with exclusive federal authority

¹ Currently dealers have the ability to “meet or beat” the interest rates offered by their competitors which frequently results in consumers getting lower rates than those offered by banks, credit unions, *as well as other dealers*. This intense market competition generates downward pressure on all prices as other lenders in the market know the dealer can negotiate down to win the sale. As a result, the current system yields credit that is widely available and very competitively priced. (See attached infographic.)

over motor vehicle dealers.² Congress specifically designed the rulemaking process to ensure that new regulations benefit from public input and scrutiny before they are issued.

Discrimination in any market – including indirect auto financing – has no place in society, and NADA fully supports the efforts of the CFPB and other federal agencies to eliminate it from the marketplace. However, as it relates to unintentional disparate impact discrimination, it is important to recognize that the efforts of federal regulators can only be successful if they engage in several essential steps. These steps include the following:

- regulators must understand the market they are examining;
- regulators must develop appropriate methodologies for accurately measuring whether disparate impact exists in that market; and
- to the extent that disparate impact is found to be present, regulators must address it in a manner that both accomplishes its purpose and is consistent with the interests of consumers.

Unfortunately, the CFPB has not followed any of the essential steps described above.

Congress is still awaiting critical details about the CFPB’s disparate impact testing methodology. The CFPB’s lack of transparency has deprived stakeholders of a meaningful opportunity to determine if there are flaws in its initiative. As noted by Senator Jeanne Shaheen (D-NH), it is critically important that the CFPB’s efforts in this regard are “done in a fair and transparent way that gives the public an opportunity to weigh in.”³

As recognized and demanded on several occasions by bipartisan members of the House and Senate, the CFPB needs to identify the complete methodology it employs to measure whether statistically significant disparate impact exists in an auto lender’s portfolio. Otherwise, one can have little confidence that the Bureau’s model is producing reliable results. This requires, among other things, that the Bureau fully account for neutral, legitimate factors that affect dealer compensation which are completely unrelated to a consumer’s background.

It is also essential that the Congress fully consider the assumptions that support the statement in the CFPB Guidance that auto lenders can ensure they are complying with the Equal Credit Opportunity Act (ECOA) by “eliminating dealer discretion” through the adoption of an alternative form of dealer compensation such as the payment of “a flat fee per transaction” or similar approach. This compliance step is flawed in two significant regards.

First, a broad industry move by finance sources to eliminate dealer discretion through the payment of flat fees will, quite simply, fail to eliminate dealer discretion. This is because dealers typically sell credit contracts to a variety of finance sources. Each finance source would set its own flat fee, and dealers would have discretion to select the finance source to which they sell the

² Section 1029 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) precludes the CFPB from exercising any authority over motor vehicle dealers engaged in indirect financing and further provides that the federal agencies who could exercise jurisdiction over dealers prior to the enactment of section 1029 continue to have authority over dealers.

³ Press release by Senator Shaheen, “*Portman, Shaheen Lead Bipartisan Group of Senators in Pushing for CFPB Transparency Regarding New Policy Guidance That Could Harm Auto Dealers and Consumers*,” Oct. 30, 2013.

contract. While this may address the fair lending risk for individual finance sources, it will not address whatever fair lending risk may exist for the consumer.

Second, a broad industry adoption of flat fees would remove the ability of dealers to cut into their own retail margins and win a customer's business by "meeting or beating" a competitive offer available to the consumer from another financing source. This will weaken competition and, in turn, drive up the cost of credit. This would adversely affect consumers, particularly credit challenged consumers who could lose access to conventional financing for their transportation needs. Democrats and Republicans in Congress have expressed concerns about this, and we hope the Bureau will respond to those concerns by analyzing this undesirable consequence.

These significant flaws in the CFPB's policy could have been avoided if the Bureau had employed a process that was data- and market-driven and transparent. Nearly all that is known on the record about the Bureau's disparate impact initiative is what has been derived from congressional oversight. Accordingly, continued oversight by the House Financial Services Committee is critical to protect consumers and small businesses.

The Avoidance of the Rulemaking Process

Through its Guidance, the CFPB is attempting to significantly alter the operation of a large and efficient market without following the standard rulemaking process and without considering the stakeholder input, public comments, and cost/benefit analysis that are associated with it. By avoiding the rulemaking process, the CFPB did not have to:

- reveal the methodology it employs to determine whether disparate impact discrimination exists;
- convene a panel to ascertain what impact its new policies would have on small business;
- give the public and affected stakeholders an opportunity to comment on the record; and
- conduct a cost/benefit analysis.

A CFPB official has characterized the CFPB Guidance as "simply [a] restatement of existing law."⁴ However, the CFPB's Guidance could, in fact, fundamentally change how vehicles are financed. The regulatory uncertainty that the Guidance has produced within the vehicle financing industry and the numerous unanswered questions from Congress and others concerning the Guidance show that it is much more than a restatement of existing law.

The Lack of Transparency

The CFPB has failed to provide analysis to substantiate its Guidance despite bipartisan calls for transparency from Congress. Since a valid showing of "disparate impact" is entirely based on a statistical analysis of past transactions, Members of Congress have asked the Bureau which statistical controls it employs to ensure that customers from different groups who are being compared are "similarly situated." However, even with congressional oversight hearings and

⁴ "The Consumer Financial Protection Bureau's Semi-Annual Report to Congress: Hearing before the Senate Banking, House and Urban Affairs Committee, 113th Cong., 1st Sess. 17 (2013).

eleven congressional letters⁵ sent by Democrats and Republicans alike, the CFPB has failed to answer this and other essential questions. As an example, in one reply to Congress, the Bureau stated the analytical controls it uses are “appropriate”⁶ – but did not identify the specific controls it employs. Since the CFPB has still not provided this essential information to substantiate its claims, there is no way to conclude whether its methods for measuring disparate impact are reliable.

Another area where Congress has inquired but not received complete answers from the Bureau is the methodology it employs to identify members of a protected class, which is a prerequisite for a disparate impact claim. Unlike in the mortgage arena, information identifying a person’s race, gender, or national origin is not collected on an auto loan application. The CFPB uses a proxy methodology that assigns a *probability* that a particular applicant is of a certain race, gender, or ethnic background. The accuracy of this proxy data is crucial. If the person whom the CFPB claims is a victim of disparate impact is not in fact a member of a protected class, discrimination has not occurred. On October 30, 2013, the CFPB was asked by 22 Senators to “provide the quantitative degree of accuracy that applies to [the proxy] methodology for each group of consumers the Bureau has examined.”⁷ No answer to this request was provided.

The Ally Settlement

The CFPB’s failure to provide an answer to the Senators on the accuracy of its proxy data is troubling, as it could result in non-minorities being improperly compensated for disparate impact discrimination. On December 20, 2013, the CFPB announced consent agreements that the CFPB and the Department of Justice (DOJ) entered into with Ally Financial, Inc. and Ally Bank (Ally), a major indirect auto lender, in a case which involved allegations of disparate impact discrimination. The CFPB issued a press release that day stating “[t]he CFPB and DOJ determined that more than 235,000 minority borrowers paid higher interest rates for their auto loans between April 2011 and December 2013 because of Ally’s discriminatory pricing system.”⁸ Yet, according to aspects of the proxy methodology the CFPB has chosen to reveal to Congress, the “235,000 minority borrowers” exist only as a probability, despite the CFPB presenting this figure in its press release as the *actual* number of minority consumers who were allegedly harmed. The CFPB’s assertions of fact in its press release demonstrate why it is important for the CFPB to reveal the accuracy of the proxy methodology supporting its assertions.

The Ally consent agreement is not proof that the CFPB’s drive to eliminate a dealer’s ability to discount credit in the showroom is justified. Based on facts listed below, the Ally consent agreement appears simply to be a rational business decision made in the current regulatory atmosphere. We urge the Committee to consider the following facts:

- Ally did not admit to any findings or conclusions in the consent order, other than that the CFPB had jurisdiction over Ally.

⁵ These letters can be accessed at: <http://www.nada.org/legislativeaffairs/economy-financial/cfpb/default>

⁶ Letter from the Hon. Richard Cordray, Director, CFPB, to Rep. Terri Sewell (D-AL) (June 20, 2013).

⁷ Letter from Senators Portman, Shaheen et. al to the Hon. Richard Cordray, Director, CFPB (Oct. 30, 2013).

⁸ Press Release by the CFPB, “CFPB and DOJ Order Ally to Pay \$80 Million to Consumers Harmed by Discriminatory Auto Loan Pricing,” (Dec. 20, 2013).

- The case against Ally was based entirely on statistics and methodologies which have not been revealed publicly or to Congress. The public still does not know whether the Bureau takes into account legitimate factors that can affect finance rates – for example, a dealer’s ability to lower its interest rate to meet a competitive offer or the customer’s monthly budget needs. Indeed, Ally released a statement when the consent order was announced saying that “based on the company’s analysis of its business, it does not believe that there is measurable discrimination by auto dealers.”⁹ This statement is evidence that CFPB did not perform a comprehensive regression analysis (i.e., one that includes all the relevant factors, not simply those chosen by the CFPB).
- Three days after the Ally consent order, the Federal Reserve Board approved Ally's application to become a financial holding company, enabling Ally to continue offering insurance products and other services that Ally might have been forced to discontinue. According to the *Wall Street Journal*, “Standard & Poor's Ratings Services... warned it would potentially lower the company's ratings if it failed to secure financial holding company status.”¹⁰
- According to *Automotive News*, “the CFPB was one of a number of regulators that had input on the Federal Reserve's decision on financial holding company status.” An Ally official stated that “[n]o investor publically was going to invest in us unless we got financial holding company status. And we could not do that without coming to terms with the CFPB.”¹¹
- On March 27, 2013, Ally announced an initial public offering where the U.S. government “would sell the bulk of its stake in the company.”¹² (At the time of the consent order, the U.S. government had a 64 percent controlling interest in Ally.)

The Unknown Costs of the CFPB’s Drive to Eliminate Dealer “Meet or Beat” Financing

Section 1022 of the Dodd-Frank Act requires the CFPB to consider, when issuing a rule, the potential benefits and costs (including the potential reduction of consumer access to financial products and services) that could be caused by such a rule. One consequence of its avoiding the rulemaking process is that the CFPB avoids having to conduct, and does not benefit from, a study into the potential impact its new policy would have on consumers. In response to a letter sent by 22 Senators, the CFPB acknowledged that it never studied how eliminating a dealer’s ability to discount credit would affect the cost of credit paid by consumers.¹³ Reducing a strong competitive force from the vehicle financing marketplace will likely raise the cost of credit for consumers. Moreover, according to Fitch Ratings, the CFPB’s drive to eliminate or severely limit “meet or beat” financing offered by auto dealers “will likely raise lender regulatory costs in 2014.”¹⁴

Together, the weakening of competition and higher regulatory costs can be expected to result in higher credit costs for consumers. And, most troubling, the CFPB’s actions could

⁹ Ally Financial Statement on Auto Financing Consent Orders, Dec. 20, 2013.

¹⁰ Andrew Johnson, “Ally Receives Fed Approval for Financial Holding Company Status,” *Wall St. Journal*, Dec. 23, 2013.

¹¹ Jim Henry, “Ally won’t be a ‘Trojan horse’ -- Lender sticks with dealer reserve, defies CFPB,” Feb. 3, 2014.

¹² Tanya Agrawal, “U.S. government to sell most of Ally Financial stake in IPO,” *Reuters*, Mar. 27, 2014.

¹³ Letter from the Hon. Richard Cordray, Director, CFPB to Senators Portman (R-OH) and Shaheen (D-NH) (Nov. 4, 2013).

¹⁴ “Fitch: CFPB Review of Auto Dealer Markups May Raise Lender Cost,” *Reuters*, Jan. 16, 2014.

disproportionally hurt consumers with less-than-perfect credit since those customers will be less able to afford any higher rates and will therefore have even more limited options to buy a car or truck to meet their work and family needs.

The Assertion That the CFPB is Not Pushing the Industry to Flat Fees

The CFPB claims that it is not pushing the industry to flat fees, and in support of that claim it cites the existence of another compliance option in its Guidance: constraining dealer discretion accompanied by monitoring. In fact, the CFPB makes actual implementation of this latter option – constraining dealer discretion and monitoring – highly impractical. This option involves “imposing controls” on dealer reserve and then monitoring dealer behavior to ensure that those controls work. However, there are several problems for a lender with this option:

- First, the CFPB refuses to explain the rules for monitoring – that is, the Bureau will not tell lenders how to ensure that they are comparing “apples to apples.” Many aspects of a vehicle financing transaction have nothing to do with the background of the borrower, and these variables could lead to differentials in the amount of compensation a dealer gets paid for originating the financing. These include factors such as:
 - borrower creditworthiness;
 - the amount financed;
 - the presence of a competing offer from another financing source;
 - the length of the loan; and
 - the presence of a manufacturer subvention of the rate (for example, a special promotional program on a certain model vehicle).

If neutral, business-related factors such as these are the reason why the amount of a dealer’s finance compensation varies from consumer to consumer, there is no unlawful discrimination. Hence, to do a proper comparison, these variables need to be held constant as part of the CFPB’s analysis. But the CFPB will not let lenders know which factors should be held constant in completing a disparate impact review.

- Second, the CFPB still refuses to divulge the numerical basis point threshold at which the Bureau concludes that statistically significant pricing disparities exist. The CFPB apparently wants lenders to monitor dealer behavior without stating at what threshold disparate impact begins.

The Bureau’s Guidance requires indirect auto lenders to guess at what controls and thresholds the CFPB would find appropriate. This lack of clarity indicates that there really is no safe harbor that can be achieved through “monitoring.” Moreover, the CFPB has stated that the analytical controls necessary to measure disparate impact are to be determined on a “case by case”¹⁵ basis which is contrary to the intent of “guidance” meant to govern the behavior of an entire industry. Indeed, the CFPB has not offered one example of a discretionary dealer compensation approach that indirect finance sources can adopt which is consistent with its March 2013 Guidance.

¹⁵ Letter from the Hon. Richard Cordray to Rep. Colleen Hanabusa (D-HI) 3 (Feb. 6, 2014).

Since CFPB refuses to tell lenders what to monitor and how, and the only other compliance option it proffers is a flat fee approach,¹⁶ the only logical conclusion a reasonable person can draw from the March 2013 Guidance is that this is the only compensation model that a finance source can adopt that will withstand CFPB scrutiny. Nothing in the Equal Credit Opportunity Act or its implementing regulation, Regulation B, requires the adoption of this compensation model as the sole means of complying with its mandates.

NADA's "Better Approach"

Despite the fact that the CFPB's "disparate impact" allegations are unexplained and unsubstantiated, in January 2014, NADA released its *Fair Credit Compliance Policy & Program* (the "NADA Program") to assist its members in addressing even the possibility of retail level discrimination in dealer-assisted financing. And, unlike the CFPB's approach, the NADA Program not only actually addresses the possibility of disparate impact, it does so in a way that is both pro-consumer and pro-competitive.¹⁷

It is important to note that the NADA Program (1) is entirely voluntary, (2) has not been formally adopted by any federal agency as a means of complying with the ECOA, and (3) is not a "safe harbor" for those who elect to adopt it. These important caveats aside, the NADA Program provides a very valuable resource for our members.

First, it allows the dealer to effectively manage the discretion that it exercises by adopting a compliance approach that the DOJ embraced in 2007 in two consent orders. These orders were entered into with dealers to resolve allegations of unlawful discrimination.

While the details of the Program are comprehensive, the basic framework is simple:

- A dealer who adopts the Program establishes a "Standard Dealer Participation Rate" – that is, a standard retail margin – for its dealership;
- In each and every transaction, the dealer adds the Standard Dealer Participation Rate to the bank or finance company wholesale buy rate to establish the retail APR that the dealer offers to all prospective customers; and
- The Standard Dealer Participation Rate, which would generally be a set number of basis points, is the same for every deal and its amount is determined by the individual dealer.

In its 2007 consent orders, the DOJ prudently recognized that stopping there would deprive consumers of the ability to obtain a lower, discounted rate from the dealer when there is a legitimate business reason for the lower rate, i.e., a reason that is unrelated to the customer's background. (In contrast, the CFPB's Guidance would eliminate a customer's ability to negotiate a lower interest rate in the showroom.) Accordingly, the DOJ, in its consent orders, and NADA, in its Program, allow for a downward deviation from the Standard Dealer Participation Rate – but

¹⁶ CFPB officials have indicated that a flat percentage of the amount financed or a hybrid coupled with a flat fee per transaction would be acceptable; however, these are just variations of a flat fee.

¹⁷ A copy of the NADA Program can be found at: www.nada.org/faircredit. This publication provides an overview of the ECOA issues and a comprehensive program template that a dealer can adopt to strengthen its compliance with ECOA (along with detailed implementation instructions).

only if one of seven good faith, pro-competitive situations is present. Examples of these pro-competitive situations include where the consumer has access to a more competitive rate from another dealer or lender or where the consumer has a budget constraint. Thus, the NADA Program addresses fair credit concerns by promoting a standardized approach that a dealer can adopt to determine its retail margin while preserving sufficient flexibility to allow consumers to benefit from the overwhelming competitive forces that exist in today's auto financing marketplace.

The NADA Program follows other aspects of the DOJ consent orders as well. For example, under the Program the dealer executes a form indicating whether the Standard Dealer Participation Rate or a lower dealer participation rate was included in a credit offer to a consumer. If a lower rate was included, it indicates the allowable reason for deviation that applies. And, the dealer records this determination for every deal.

In addition, as with any sound regulatory compliance program, the NADA Program requires a comprehensive set of procedures to effectively carry it out. This includes responsibilities related to training, document review and retention, monitoring, auditing, reporting, coordination, and oversight. In this way, the NADA Program – while completely modeled on the DOJ consent orders – actually contains procedures that are more robust.

While there is no perfect solution to the task of effectively managing discretion, the NADA Program can set a dealer on a clear path towards addressing fair credit concerns at the retail level. Accordingly, the NADA Program should be of benefit to all of the parties to an indirect vehicle financing transaction – consumers, dealers, and finance sources alike.

Pushing the Industry Toward Flat Fees by “Portfolio Monitoring”

Under its 2013 Guidance, the CFPB expects lenders who retain a discretionary dealer compensation system to monitor for potential fair credit violations on both a dealer-specific and portfolio-wide basis. Monitoring on a portfolio-wide basis is problematic, as it could suggest that there is alleged pricing discrimination even when no statistically significant pricing differentials are found to exist in the credit contracts purchased from each of that lender's dealer clients.

For example, assume that a dealer in Maine (Dealer A), which operates in an area that primarily consists of non-minority customers, assesses its local market conditions and charges 70 basis points in dealer participation on each and every auto financing transaction that it arranges for consumers, while a dealer in Hawaii (Dealer B), which operates in an area that primarily consists of minority customers, charges 95 basis points on each transaction. Because each dealer charged their respective customers the exact same amount for the services they provide, neither Dealer A nor Dealer B engaged in any form of discrimination. However, if a bank buys paper from both these dealers and monitors these transactions, it will find that while no pricing disparities exist at the retail level, pricing disparities nevertheless exist within its own portfolio. Such a distortion, *which the CFPB maintains must be avoided even if disparate impact is found not to be present at the retail level*,¹⁸ has no support in public policy and is a further (and, indeed, a dispositive)

¹⁸ See Kate Davidson, *Officials: Scrutiny of auto loans a big priority for CFPB and Justice*, Politico Pro, Apr. 14, 2014 (“While CFPB Director Richard Cordray has said the NADA initiative is encouraging, Rebecca Gelfond, CFPB’s deputy fair lending director, warned that the program is “a dealer-level response. The concern is that people

example of how the CFPB has provided finance sources with only one viable path to meeting its enforcement expectations – the adoption of a flat fee or other non-discretionary payment mechanism that does not require portfolio monitoring. Stated differently, because retail margins necessarily differ based on local market conditions and because the demographics of the populations that dealers serve also differ, pricing disparities in a finance source’s portfolio are inevitable even when the finance source finds no unexplained pricing disparities at the retail level. This creates significant – and completely unjustified – liability exposure for finance sources that is inconsistent with the language and intent of the Equal Credit Opportunity Act.

Rebuttal of Reports by the Center for Responsible Lending

In 2011 and 2014, the Center for Responsible Lending, a group affiliated with economic competitors of auto dealers, released two reports attacking the indirect financing model. The purpose of these reports apparently is to advocate for more government regulation on automobile dealers. Because some Members of Congress have relied on the erroneous conclusions and flawed methodology found in these reports, we have attached and respectfully ask the Chairman to include NADA’s rebuttals to these reports in the hearing record.

Conclusion

The indirect vehicle financing model is extraordinarily efficient, competitive and provides access to affordable credit to consumers in all credit tiers. Competition is currently fostered by, among other things, the ability of dealers to “meet or beat” the best interest rate offer that consumers can secure from other creditors, such as a bank, a credit union, or another dealer.

The CFPB is pressuring finance sources to eliminate a dealer’s ability to discount credit in the showroom and replace it with a flat fee compensation model, thus eliminating the “meet or beat” dynamic that is critical to vigorous competition in the auto finance marketplace. What is most ironic is that the CFPB’s push for a flat fee approach is being made in the name of addressing fair credit risk when that approach simply does not accomplish the Bureau’s goal. Whatever fair credit risk exists with discretion in the current system will still exist under a flat fee approach, because dealers would retain discretion under a flat fee model to choose the lender to whom they assign financing. A better approach that both directly addresses fair credit risk and preserves market flexibility and competition for the benefit of the consumer is embodied in the NADA Fair Credit Compliance Program. We urge Congress to explore ways of encouraging greater consideration of this model.

might assume that the dealer solution would also be a solution at the lender level,” Gelfond said at a Consumer Bankers Association conference in Maryland. “I don’t think that lenders should be making that assumption”).